

Decision **REVISED PROPOSED DECISION OF ALJ FUKUTOME**
(Mailed 2/11/2004)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY (U 133-W), for an order authorizing it to increase rates for water service by \$19,826,100 or 29.72% in the year 2003; by \$6,327,800 or 7.31% in the year 2004; and by \$6,326,200 or 6.81% in the year 2005 in its Region III Service Area and to increase rates for the General Office Allocation in all of its Customer Service Areas in this Application including: Arden-Cordova, Bay Point, Clearlake, Los Osos, Ojai, Santa Maria, Simi Valley and Metropolitan.

Application 02-11-007
(Filed November 4, 2002)

OPINION RESOLVING APPLICATION

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OPINION RESOLVING APPLICATION

1. Summary

This decision grants Southern California Water Company (SCWC) authority to increase rates by \$8,097,000 or 12.06% in the year 2003; by \$1,891,600 or 2.50% in the year 2004; and by \$2,789,100 or 3.60% in the year 2005 in its Region III Service Area. Rates for Region III will continue to be determined on a regional, rather than district specific, basis. SCWC's request to also increase rates for the General Office Allocation to customer service areas (CSAs) in Regions I and II is denied. Beginning in 2003, revenues derived from the lease of water rights to the City of Folsom will be used to offset the cost of service for the Arden-Cordova CSA. The following table summarizes the authorized rate increases for Region III.

District	2003		2004		2005	
Region III						
Orange	\$4,647,200	17.69%	\$ 899,300	2.89%	\$ 1,198,800	3.75%
Claremont	520,800	4.83%	332,700	2.93%	438,900	3.75%
San Dimas	1,021,400	7.90%	145,500	1.04%	530,700	3.76%
San Gabriel	720,000	11.40%	332,300	4.71%	276,900	3.75%
Barstow	1,187,800	17.80%	84,300	1.07%	311,100	3.93%
Calipatria-Niland	-	0.00%	97,500	9.17%	32,700	3.93%
Desert	-	0.00%	-	0.00%	-	0.00%
Wrightwood	-	0.00%	-	0.00%	-	0.00%
Total Region III	\$8,097,000	12.06%	\$1,891,600	2.50%	\$2,789,100	3.60

2. Background

2.1. Procedural History

SCWC filed this general rate case (GRC) application pursuant to Pub. Util. Code § 454,¹ which governs proposed rate changes. The company requests Commission authorization to increase rates in its Region III Customer Service Areas, which include Orange County, Claremont, San Dimas, San Gabriel Valley, Barstow, Calipatria-Niland, Desert and Wrightwood. In addition, SCWC requested authority to increase current authorized revenues for the General Office for certain other CSAs that are not in for a GRC at this time.

The Office of Ratepayer Advocates (ORA) and the Orcutt Area Advisory Group filed protests to the application. Also, the Cities of Claremont and San Dimas sent a joint letter, to the assigned administrative law judge (ALJ) for this proceeding, indicating their opposition to the rate increases. A Prehearing Conference (PHC) was held on January 31, 2002. SCWC, ORA and the City of Claremont filed appearances.

The Assigned Commissioner's Scoping Memo and Ruling was issued on February 28, 2003. That ruling set forth the scope, schedule, category, assignment of the principal hearing officer and ex parte communications rules for this proceeding, pursuant to Rule 6.3 of the Commission's Rules of Practice and Procedure (Rules).

On March 21, 2003, an ALJ ruling granted the requests of the City of San Dimas and the City of Ojai to intervene as interested parties. A similar request

¹ Unless indicated otherwise, all statutory citations are to the Public Utilities Code.

by the Wrightwood Property Owners Association (WPOA) was granted in a March 28, 2003 ruling.

On April 8, 2003, ORA, the City of Claremont, the City of San Dimas and the WPOA issued testimony addressing SCWC's request.

Public participation hearings (PPHs) were held the morning and evening of April 28, 2003, in Claremont and the afternoons and evenings of April 29, 2003, in Stanton and April 30, 2003, in Barstow. Approximately 400 ratepayers attended the two Claremont hearings, with 45 persons speaking. In afternoon and evening sessions, there were approximately 20 attendees in Stanton, with eight speaking, and approximately 50 ratepayers attending in Barstow, with 12 speaking. The Cities of Claremont and San Dimas participated at the Claremont hearings, while representatives of WPOA spoke at the afternoon session in Barstow.

The participation of public speakers was wide and varied. Mayors, city council members, chamber of commerce representatives, members and leaders of a number of civic groups as well as individual ratepayers representing themselves made their views known. At Claremont, the ALJ was presented with a petition signed by approximately 600 citizens, who opposed the proposed increases. At the Claremont and Stanton hearings, discussion focused on the comparison of rates for neighboring cities and water companies. In Barstow, water quality was a principal issue. In all three PPHs, the issue of regional, as opposed to district specific, rates was discussed. The proportionally high nature

of the service charges² and the plight of senior citizens and low-income residents were also central themes.

On May 1, 2003, SCWC issued rebuttal testimony. An evidentiary hearing on the application was conducted over five days beginning on May 12, 2003. The company, ORA, the City of Claremont, and the City of San Dimas presented witnesses. Opening briefs were filed on June 16, 2003 and reply briefs on June 30, 2003. SCWC and ORA were the only parties that participated in the briefing.

On June 11, 2003, the Commission's Water Division issued its Report on Southern California Water Company's Regionalization of Rates in Region III.³ On July 8, 2003, comments on the Water Division report were filed by SCWC, ORA, the City of San Dimas and the City of Claremont. This matter was deemed submitted for decision as of that date.

Additionally, hearing was held on June 17, 2003 to consider a proposed joint SCWC/ORA stipulation exhibit. A motion to accept the Stipulation was then filed by SCWC/ORA on July 14, 2003. No. comments were received.

² Related to the high service charge issue, there were ratepayer complaints about the effect of local requirements to install sprinkler systems in houses for fire protection. Because of the sprinkler systems, larger service meters are required, and the monthly service charges for those larger meters are significantly higher than for meters that would normally serve the residences. Both the company and ORA indicated there were rate design options that would mitigate that effect.

³ D.00-06-075, Ordering Paragraph 5, in part, directed the Water Division "to monitor the impact of single tariff pricing and report to the Commission in the next general rate case for SCWC's Region III with any recommendations for change in this pricing mechanism."

2.2. SCWC's Request

Following is a summary of SCWC's requested rate increase, as reflected in its application.

District	2003		2004		2005	
Region III						
Orange	\$7,953,900	30.39%	\$4,579,300	13.39%	\$2,786,400	7.19%
Claremont	3,279,200	30.47%	156,100	1.11%	1,008,400	7.09%
San Dimas	4,082,000	31.92%	165,100	0.98%	1,209,800	7.10%
San Gabriel	2,266,000	36.02%	406,300	4.77%	648,500	7.26%
Barstow	1,978,600	29.99%	1,032,900	12.14%	612,600	6.42%
Calipatria-Niland	266,000	25.57%	5,800	0.44%	62,500	4.76%
Desert	-		-		-	
Wrightwood	-		-		-	
Total Region III	19,825,700	29.79%	6,345,500	7.31%	6,328,200	6.81%
Arden-Cordova	732,743	10.71%	301,625	3.98%	301,625	3.83%
Bay Point	140,995	2.94%	68,972	1.40%	68,972	1.38%
Clearlake	46,200	3.38%	22,648	1.60%	22,648	1.58%
Los Osos	91,957	4.67%	42,207	2.05%	42,207	2.01%
Metropolitan	4,055,241	5.32%	1,851,958	2.31%	1,851,958	2.25%
Ojai	108,092	4.35%	54,560	2.10%	54,560	2.06%
Santa Maria	358,913	5.57%	169,857	2.50%	169,857	2.43%
Simi Valley	422,421	5.31%	195,078	2.33%	195,078	2.27%
Total Company	25,782,662	14.75%	9,034,705	5.86%	9,033,105	5.49%

2.3. ORA's Recommendation

Following is a summary of ORA's recommended rate increase as modified by the errata contained in Exhibit 52, dated June 1, 2003.

District	2003		2004	
Region III				
Orange	\$ (929,000)	-3.50%	\$ 124,111	0.48%
Claremont	472,800	4.29%	\$ 337,894	2.92%
San Dimas	(277,100)	-2.08%	\$ 403,384	3.08%
San Gabriel	(279,900)	-4.30%	\$ 139,362	2.23%
Barstow	283,300	4.10%	\$ (65,894)	-0.92%
Calipatria-Niland	419,500	37.47%	\$ 174,555	11.17%
Desert	721,600	41.10%	\$ 227,598	9.08%
Wrightwood	258,000	18.76%	\$ 72,199	4.39%
Total Region III	669,200	0.98%	1,413,210	2.05%

In its testimony, ORA recommended that rates be determined on a district specific basis rather than the current regional basis. Additionally, ORA recommended that SCWC's request for an incremental general office increase for Regions I and II be rejected. ORA supports an attrition increase for 2005, based on its recommended attrition mechanism, but did not quantify that amount.

2.4. Position of the City of Claremont

The City of Claremont recommended that the Commission reject SCWC's application to increase rates. The concerns expressed included the high rates of the Claremont CSA compared to that charged by agencies providing water in neighboring communities, SCWC's history of significant rate increase requests and the subsidizations caused by regional rates.

2.5. Position of the City of San Dimas

The City of San Dimas opposed the rate increases proposed by SCWC. The concerns highlighted were the proposed return on equity and regional rates.

2.6. Position of WPOA

WPOA supported the continuation of the single tariff rate structure that was authorized by the Commission for Region III in 2000.

3. Stipulation

SCWC and ORA filed a motion on July 14, 2003, requesting that the Commission adopt a proposed stipulation (Stipulation) that would resolve many, but not all, of the issues in this case. The following is a summary of the Stipulation.

Region III	SCWC Pre-Stipulation	SCWC Stipulation	Remaining Difference	ORA Stipulation	ORA Pre-Stipulation
2003 At Proposed Rates	\$ 86,542,200	\$ 80,273,000	\$ 6,698,400	\$ 73,574,600	\$ 69,242,000
At Present Rates	66,717,900	67,156,900	(1,200,200)	68,357,100	68,572,300
Increase	19,824,300	13,116,100	7,898,600	5,217,500	669,700
2004 At Proposed Rates	\$ 92,881,300	\$ 83,716,200	\$ 7,760,900	\$ 75,955,300	\$ 71,038,500
At Present Rates	66,724,400	67,472,400	(1,204,500)	68,676,900	68,945,700
Increase	26,156,900	16,243,800	8,965,400	7,278,400	2,092,800

The Stipulation is attached to this decision as Appendix I. We have reviewed that document along with the supporting appendices and conclude that the proposal to subject 51 capital projects to advice letter filings should be rejected. Rather than adopting the advice letter proposal, we estimate that \$4,643,230 of plant additions will go into service, on average, beginning January 1, 2005. We estimate the revenue requirement effect to be \$758,700 and will include that amount in the 2005 attrition year increase. SCWC is also authorized to file a separate application for recovery of the Calipatria treatment plant costs, or in the alternative may include the costs for review in the next GRC. Also, our resolution of issues related to SCWC's Cash Preservation Plan precludes the adoption of the maintenance expense portion of the Stipulation.

3.1. Plant

The following table shows SCWC and ORA estimates of plant additions before and after the Stipulation, as well as the remaining contested differences.⁴

Gross Plant Additions

	2002	2003	2004	3 Year Total
Before Stipulation				
SCWC	\$16,923,560	\$49,075,403	\$31,241,380	\$97,240,343
ORA	4,163,310	25,802,258	16,117,833	46,083,401
Difference	\$12,760,250	\$23,273,145	\$15,123,547	\$51,156,942
Stipulation				
GRC Budget	\$ 4,390,253	\$20,481,233	\$15,819,913	\$40,691,399
Advice Letter	460,600	14,190,922	7,479,466	22,130,988
Total Stipulation	\$ 4,850,853	\$34,672,155	\$23,299,379	\$62,822,387
Contested	\$ -	\$15,250,193	\$ 5,412,500	\$20,662,693

The table indicates that much of the original difference between SCWC and ORA was for projects that would, under terms of the Stipulation, be subject to advice letter filings. In its testimony, ORA recommended such treatment for a number of projects, resulting in much of the original revenue requirement difference with SCWC. ORA and SCWC have agreed that while there may be a need to undertake 51 individual projects, the timing, scope or estimates of cost are questionable. The parties would rather subject these projects to advice letter procedures than have these projects included in rates on an estimated test year basis. Fifteen projects relate to conservation expenditures, which ORA asserts are

⁴ All data derive from the Stipulation, Section 2.00. Data reflect a stipulated 22.5% overhead as opposed to the 25% as originally filed by SCWC.

uncertain, due to prior SCWC deferrals in this area. Thirteen other projects relate to water supply items such as wells and reservoirs. Both SCWC and ORA made estimates for the Calipatria treatment plant but now agree to subject the related 23 individual projects to advice letter treatment after actual contractor bids of \$13.2 million and \$18.9 million far exceeded SCWC's original estimate of approximately \$9.2 million. For this GRC, the parties propose advice letter treatment for the Calipatria treatment plant projects to be capped at \$10.3 million, with any additional costs to be included in the next GRC.

We are concerned with the implementation of the Stipulation as it relates to the advice letter filings. The number of rate changes that will result from the proposal is not clear. Under Section 2.04 of the Stipulation, "ORA and SCWC agreed that SCWC is authorized to file advice letters seeking authorization to include in rate base, upon completion, the actual costs of the plant additions set forth herein and to receive a corresponding rate adjustment for the additional rate base." It could be interpreted that SCWC would be authorized to make as many as 51 advice letter filings, each with an associated rate change over the remainder of this rate case cycle. Since, as discussed further in this decision, we are maintaining regional rates, consideration of each of those rate changes would have to be given to each of the districts in Region III. Not only would this proposal place a burden on the Commission staff in evaluating and processing the filings, but it would also be extremely confusing to customers

The magnitude of dollars that are to be subject to advice letter filings under the stipulated agreement is substantial. Advice letter projects represent approximately 25% of the total plant additions now being considered for the years 2002- 2004. Depending on the timing of the additions, the \$22 million related to advice letter projects could generate a further annual increase of as

much as \$3 million to \$4 million, or approximately another 5% over the rate case cycle.

Advice letter filings for capital projects are appropriate for large projects that do not occur regularly and where the timing is at issue. The necessity, scope and cost of the project would be defined and an advice letter review would have specific parameters to verify before the implementation of a rate change. In total the Calipatria treatment plant project is a large project and timing is certainly an issue. However, the cost and subsequently the scope of the project are uncertain due to the disparate cost estimates as described above. Advice letter verification of reasonable costs is therefore problematical. We note that a similar project was considered in the test year 2000 GRC⁵ and was afforded advice letter treatment. We stated:

“For the Calipatria-Niland District, major plant additions are required to meet the Enhanced Surface Water Treatment Rules as determined by EPA and DHS. These rules are currently in effect. SCWC proposes that the \$ 2.6 million cost be spread over the years 2000, 2001, and 2002. Because the costs of plant additions to comply with these rules are certain, rather than require SCWC to file a separate application as required for the proposed radon and arsenic facilities, we will adopt the recommendation of the stipulation that these costs be recovered through an Advice Letter. In the meantime, these costs should be accrued in a memorandum account, with carrying costs computed using the authorized rate of return, without gross-up for taxes.”⁶

This project was apparently not done and the current treatment plant project is being proposed. However in the current case, the costs of plant

⁵ See D.00-06-074 in A.99-05-035, et al.

⁶ D.00-06-074, 2000 Cal. PUC LEXIS 345

additions are not certain. It is therefore reasonable to consider cost recovery for the project in a separate application, rather than through advice letter. In the alternative, SCWC can include the recorded costs in the next GRC. In either case, the company must justify the recorded expenditures and, given the disparate cost estimates, address its consideration of alternatives to the proposed project, or aspects of the project, in order to mitigate the financial impacts. As before, we will allow SCWC to accrue the costs in a memorandum account, with carrying costs computed using the authorized rate of return, without gross-up for taxes.

The proposed advice letter proposal results in after-the-fact cost recovery for capital projects on a recorded cost basis, which conflicts with the idea of test year ratemaking where reasoned estimates are the basis for rate recovery and where, at least for the rate case period, certain shareholder/ratepayer risks are associated with potential over-spending or under-spending of adopted test year amounts. From this standpoint it is not appropriate to include normal projects that should be handled on an estimated test year basis, through advice letter filings. SCWC's conservation, well replacement, reservoir and "manganese filter, crooks" projects fall into this category. Rather than subject these projects to the proposed advice letter process, we will include appropriate costs in the estimates for this GRC, based on the record of this proceeding. Testimony and rebuttal testimony by all parties were prepared and received into evidence during evidentiary hearings. The need for the "manganese filters, crooks", for the Barstow CSA, was not discussed or justified by either SCWC or ORA; and we will not authorize recovery in this GRC. Estimates for replacement well, reservoir and conservation projects are discussed below.

Well replacement projects total \$6,172,146. Many of the wells are nearing the end of their useful life and in order to minimize purchases of imported water, SCWC planned to begin a program to construct replacement wells.

For the San Gabriel well, ORA indicates that with no action the total remaining capacity of all the wells in this CSA would still be 98% of current capacity, the loss of only 2% of well capacity would not impact SCWC's operation adversely. The immediate need for this well is therefore at issue. The record does not substantiate such need, and we will not authorize cost recovery in this GRC cycle.

For the Lucerne Valley well, ORA indicates that SCWC is scheduled to build a reservoir in 2004 to assist the Lucerne Valley area in meeting fire flow requirements and maximum peak demand and there is no urgency to build this well in the same year. ORA recommends that it be deferred to 2005. SCWC did not rebut this recommendation.

For the remaining 7 wells, the issue is mainly one of cost. For the San Dimas well, two Orange County wells and two Claremont wells, ORA indicates that the estimates were considerably higher than similar projects completed recently and that SCWC did not have firm contractor quotes or bids to support the estimates. ORA did not provide an estimate of the costs but recommended advice letter treatment. For the two Barstow wells, ORA's testimony states that SCWC's increase is high especially since SCWC presented no evidence to justify its 2003 estimate. Based on its analysis, ORA estimated well replacement costs of \$217,317 for 2003 and \$225,676 for 2004 (in total, 63.7% of SCWC's estimate) but recommended the advice letter process due to future uncertainties. SCWC did not rebut ORA's criticism of the cost estimates. Also, the record does not include any justification by SCWC for its cost estimates. With no better information on

which to rely, we will apply an adjustment factor of 63.7%, based on ORA's adjustments to the Barstow wells, to SCWC's estimate for each of the 8 well projects, including the Lucerne Valley well, resulting in plant additions totaling \$3,517,230. We assume, on average, the wells will be operational at the beginning of 2005 and will include the revenue requirement in the attrition year allowance.

Reservoir projects total \$2,503,810. The Orange County reservoir site is needed to comply with MWD regulations requiring water agencies to purchase water at a constant rate each 24 hours. Two reservoir projects in Barstow are recommended as part of a master plan for the Barstow system.

For the Orange County reservoir, ORA indicates that the purchase of the land has not been finalized and that SCWC indicated that the project might be delayed to 2006. The immediate need for this reservoir is therefore at issue. The record does not substantiate such need, and we will not authorize cost recovery in this GRC cycle.

For the two Barstow reservoirs, ORA's testimony stated that SCWC's estimates are high especially since SCWC did not present ORA with cost breakdowns of its estimates. Based on its analysis, ORA estimated reservoir costs of \$521,000 for 2003 and \$605,000 for 2004 but recommended the advice letter process due to future uncertainties. SCWC did not rebut ORA's criticism of its cost estimates. We will use ORA's cost estimate in 2004 dollars as an estimate for the Barstow reservoirs, resulting in plant additions totaling \$1,130,000. We assume, on average, the reservoirs will be operational at the beginning of 2005 and will include a full year's revenue requirement in the attrition year allowance.

Conservation projects total \$2,763,042. The Urban Water Management Plan identified water conservation, as a cost effective element of meeting water supply requirements, and this budget item is intended to carry out the

conservation projects identified in that plan. However, there is no indication of what the individual projects and associated costs are or of any cost effectiveness analysis being performed. ORA indicates that SCWC had budgeted but not spent any money on conservation projects in 2002 and the timing and costs of the projects for 2003 and 2004 were uncertain. There is insufficient information to determine the reasonableness of a conservation project budget and we will not authorize cost recovery in this GRC cycle.

3.2. Sales

Section 3.00 of the Stipulation deals with sales to customers and addresses estimates of the number of customer connections as well as sales per customer. Estimates for each were made on an individual district basis, by customer class. In total, SCWC estimated the number of Region III customer connections to be 95,675 for 2003 and 96,118 for 2004, while ORA estimated 95,936 for 2003 and 96,476 for 2004. The stipulated amounts, which total 95,776 for 2003 and 96,237 for 2004, are a reasonable resolution of the differences between the two parties.

The estimates of sales per customer for the largest customer class, commercial, remain contested in this proceeding. The Stipulation does address the sales/customer differences for the other customer classes on a district basis. For those items, we find that the stipulated values, which are a mixture of the utility estimates, the staff estimates and values in between, reasonably resolve the differences.

3.3. Labor

Section 4.00 of the Stipulation resolves differences in the estimates of district labor, while general office labor remains a contested issue. The estimates of district labor were made on an individual district basis and include district O&M, allocated district office and allocated regional office labor costs. For 2003,

SCWC estimated total district labor to be \$7,536,800, while ORA estimated the amount to be \$6,313,100. The stipulated expense total is \$6,941,300. Similarly, for 2004, SCWC estimated \$7,878,200, ORA estimated \$6,485,200 and the stipulated total amount is \$7,100,900. A portion of the district labor costs relates to maintenance expense, which we modify later in this decision when resolving issues related to SCWC's Cash Preservation Plan. For the remainder of district labor costs, the stipulated amounts appear reasonable and will be adopted.

3.4. Administrative and General (A&G) Expenses

As detailed in the Stipulation, Section 5.00, agreement was reached in the areas of office supplies, property insurance, injuries and damages (general office), injuries and damages (Region III CSAs), pensions and benefits (Region III CSAs), meals, regulatory commission expense, outside services, miscellaneous expenses, other maintenance of general plant, rent and capitalized A&G expenses. Based on the record in this proceeding, the stipulations related to A&G expenses appear reasonable and will be adopted. Also, for the allocation of costs related to the general office, common customer accounts and the region and district offices, the ORA and SCWC agree to use the updated "Revised Four-Factor" proposed by SCWC. The allocation percentages contained in the Stipulation will be adopted. Pensions and benefits for the general office was not resolved as part of the Stipulation and is discussed later.

3.5. Operation and Maintenance

From information shown in Section 6.02 of the Stipulation, for 2003, SCWC estimated total other operations expense for the Region III districts, district offices and region office to be \$1,543,000, while ORA estimated the amount to \$1,248,300. The stipulated expenses for this category total \$1,413,300. Similarly,

for 2004, SCWC estimated \$1,578,600, ORA estimated \$1,278,700 and the stipulated amount is \$1,542,800. For 2004, the fact that SCWC and ORA agree that an additional \$100,000 should be added for uranium removal costs explains why the 2004 stipulated amount is much closer to SCWC's original estimate as opposed to that of ORA. In that light, the stipulations related to other operations expense appear reasonable and will be adopted.

Section 6.03 addresses other operating expenses in the general office, excluding those related to the contested issue of SCWC's proposed Security Plan. We will adopt the stipulated portions of the forecasts, which are very close to ORA's estimates.

From information shown in Section 6.04 of the Stipulation, for 2003, SCWC estimated total other maintenance expense for the Region III districts to be \$3,452,400, while ORA estimated the amount to be \$2,081,600. The stipulated expenses for this category total \$2,550,100. Similarly, for 2004, SCWC estimated \$3,581,600, ORA estimated \$2,134,900 and the stipulated amount is \$2,603,200. Other maintenance expense relates to our resolution of the Cash Preservation Plan issue discussed later. We will therefore not adopt the stipulated amounts for other maintenance expense.

Sections 6.05 and 6.06 of the Stipulation resolve general office common customer account expense estimates (excluding labor) and general office postage reasonably. There was little difference in the ORA and SCWC estimates of common customer account expense and the stipulation for postage appears to reflect SCWC's zero-based budget and therefore the most recent postage rates.

Sections 6.01, 6.07, 6.08 and 6.09 of the Stipulation include percentage factors that ORA and SCWC have agreed to use for uncollectibles, property taxes,

payroll taxes and local taxes. Based on the record, those factors appear reasonable and will be adopted.

3.6. Supply

Section 7.00 of the Stipulation relates to water supply issues, with Section 7.01 specifically addressing source issues. The percentage of water supply derived from wells and from purchases was disputed in five of the eight districts. ORA and SCWC stipulate to supply mix ratios for four of those districts with only that for the Claremont District remaining contested. The stipulations related to sources of supply appear reasonable and will be adopted.

Section 7.02 of the Stipulation itemizes stipulated and contested supply volumes by customer class for each of the CSAs. Supply volumes are a direct result of the number of customer connections and sales per customer. As discussed above, the issue of sales per customer for the commercial class remains contested. Therefore, the Stipulation leaves the supply volume for that class unresolved. For the other classes, the numbers of customer connections and the sales per customer have been agreed to in Section 3.00 of the Stipulation, which we adopt. We therefore adopt the resultant supply volumes as shown in Section 7.02.

Supply volumes, unaccounted for water and supply mix ratios affect the supply issues described in Section 7.03 of the Stipulation. For expenses related to purchased water, purchased energy and pump taxes, ORA and SCWC agree on a procedure that uses the latest available rates prior to producing the final decision tables for 2003, as referenced in Section 8.03 of the Stipulation. We adopt the stipulated procedures for 2003. A procedure for 2004 remains unresolved by the Stipulation, since SCWC proposes to inflate the latest available rates to 2004 levels, while ORA proposes to exclude such inflation.

In Section 7.05 of the Stipulation, ORA and SCWC agree on a procedure to use SCWC's chemical unit cost per KCcf, to forecast chemical costs. Differences between their estimates of such costs are attributable to differences in estimates of sales and supply mix. We will incorporate the stipulated procedure in calculating adopted chemical costs in this decision.

In Section 7.05 of the Stipulation, ORA and SCWC agree to a procedure for determining unaccounted for water and water used in operations. For determining those quantities in this decision, we will incorporate the stipulated percentages.

3.7. Common Issues

Besides the procedure for determining rates charged for purchased water, purchased energy and pump tax, as discussed above, Section 8.00 relates to inflation factors. The use of the latest available information and a 60/40 split between the non-labor index and the compensation per hour index are reasonable and will be incorporated in determining inflation for this decision.

3.8. Audit

Section 9.00 of the Stipulation resolves issues identified in ORA's audit of SCWC, as described in Exhibit 12. SCWC agrees with ORA recommendations regarding overhead construction costs, annual financial reporting and revenue from rental of water property, and ORA revises its recommendation regarding legal costs to reflect the end of litigation related to Barstow water rights. ORA and SCWC agree that \$818,074 is properly accounted for in this GRC's rate base. Based on ORA's criticism of SCWC's determination of a construction overhead rate, ORA and SCWC have agreed on a rate of 22.5% to be applied to the general office and Region III capital budget components for the test year. These stipulations appear reasonable and will be adopted.

3.9. Other Issues

Section 10.00 of the Stipulation discusses the Water Quality OII expense amortization sought by SCWC. ORA has not stipulated to the amortization of these costs; however, so we will not consider this issue to be resolved by the Stipulation and will discuss it later.

3.10. Tariff Rules

Section 11.00 of the Stipulation addresses SCWC's proposed changes to the tariff rules. ORA agrees with proposals to modify the tariff conditions for the customer deposit level, interest paid on customer deposits and the minimum diameter for private fire protection service. We will adopt those changes. One tariff issue related to reconnection fees remains contested.

POLICY ISSUES

4. Regional or Single Tariff Rates

ORA recommends that rates for Region III be determined for each of the districts in Region III based on a cost of service analysis for each of the districts. The Cities of San Dimas and Claremont support ORA's position for district specific rates. SCWC requests that the use of regional, or single tariff, rates be continued for its Region III. WPOA supports the company's position. This decision continues the use of regional rates, continues certain reporting requirements for SCWC and provides an opportunity for this issue to be addressed again in SCWC's next Region III GRC.

4.1. Background

At the request of SCWC in A.98-09-040, the Commission issued D.00-06-075, which established single tariff rates for Region III. The issue of single tariff (or regional) rates was controversial and in adopting SCWC's request, the Commission ordered the Water Division to monitor the impact of

single tariff pricing and report in the next general rate case for SCWC's Region III with any recommendations for change. The current GRC proceeding for Region III is the proper proceeding for the Water Division to provide such recommendations.

Testimony by ORA and other interested parties was distributed on April 8, 2003. The advocacy function in water proceedings is now the responsibility of ORA rather than the Water Division. ORA recommended that regional rates be discontinued in favor of district specific rates. SCWC issued rebuttal on this issue on May 1, 2003.

On June 10, 2003, the Water Division issued a separate report on the effects of single tariff rates in Region III, specifically in response to the direction given in D.00-06-075. While the report criticizes single tariff pricing as being advantageous to SCWC's shareholders and appears to question the motives of the company in making the request for regional rates, it indicates that more time is needed to make a comprehensive assessment. The report recommends that SCWC be ordered to continue to provide the Commission with an annual report as previously ordered in D.00-06-075, along with additional information on low-income customers, and that in the next GRC, SCWC should provide the Commission with a final report that includes justification for continuation of regional rates.

4.2. Discussion

In A.98-09-040, the issue of single tariff or regional rates for SCWC's Region III was raised and fully litigated. In granting the company's request for such rates, D.00-06-075 provides a full description of the process and fully justifies the actions taken therein. In this proceeding, we have not been

presented with sufficient cause or justification for reverting to district specific rates.

The regional rate issue is a policy matter and from that perspective, there are compelling arguments for both continuing and terminating single tariff rates. While we agree with SCWC that this is a pricing rather costing issue, ORA arguments related to price signals, potential subsidies, customer input, etc. have merit. However, the arguments, some of which were addressed in D.00-06-075, and the record in this case do not convince us to change our determinations that resulted in the establishment of regional rates. In D.00-06-075, we concluded that:

“A region-wide tariff will benefit existing and future customers in SCWC’s Region III by stabilizing rates, making rates more affordable in the smaller rate districts, and facilitating investment in water supply infrastructure and water treatment facilities.”
(Conclusion of Law 1.)

We stated that an overriding concern that favors single tariff pricing is the affordability of water in several of the small communities in Region III. That concern and our conclusion in that case are also relevant to this proceeding. For example, under the numbers generated by this decision for test year 2003, a stand-alone rate methodology would result in an approximate 47% increase in rates for the Calipatria – Niland District, while the overall average increase to the region is approximately 12%. The disparate affect on Calipatria – Niland is even more dramatic when considering the contemplated water treatment plant. If and when that facility is completed, at least an additional \$10.3 million in rate base will be added to the Calipatria – Niland CSA, either in this GRC cycle by separate application or in the the next GRC. The current rate base for this district is \$2.7 million. New plant costs of \$10.3 million could cause rates to increase by an

additional 65% above the 2003 increase under district rates, while on a regional basis, average rates would increase by about 1.5%. On a district rate basis, the potential increase for the Calipatria – Niland CSA in this GRC cycle could therefore be as much as 160% when considering the test year 2003 increase, the 2004 step increase, the 2005 attrition year increase and the potential treatment plant application.

Affordability is therefore a primary consideration in this proceeding as it was in A.98-09-040. SCWC has presented information showing that customers in certain high cost districts have benefited substantially from the regional rate structure with only a moderate effect on the subsidizing districts.⁷ For instance, at the end of 2001, a customer in Morongo Valley who would have paid \$83.49/month under stand alone rates for 10 Ccf, instead paid \$47.02/month under regional rates. The subsidization by other districts can be seen in Orange County where customers who would have paid \$22.81/month under stand-alone rates for 10 Ccf, instead paid \$24.12/month under regional rates. Regarding the low-income rate program, which SCWC states can only be offered in Region III because single tariff pricing is in place, the low-income customer in Region III, on average, received an annual benefit of \$42.60 or \$3.55/month, which cost other Region III customers only \$0.32/month.⁸ From the aspect of affordability, regional rates appear to be functioning as anticipated in D.00-06-075. Since affordability continues to be a problem and regional rates can effectively address that problem, we will not alter the current rate structure as proposed by ORA

⁷ See SCWC, Conway, Exhibit 34, Table SLC-2.

⁸ SCWC Conway, Exhibit 34 at pp. 19-20.

and the City of San Dimas. Also, since we are affirming the viability of regional rates, we will not deny or defer this application as requested by the City of Claremont.

We re-emphasize that the decision, in A.98-09-040, to institute single tariff pricing in SCWC's Region III was largely policy based. It was understood that some districts would subsidize others and that the mix might change over time. It was understood that there were policy considerations and prior Commission practices that are not consistent with the idea of regional rates. However, along with the evidence presented in that proceeding, there were other policy considerations, especially that related to affordability, which persuaded us to grant SCWC's request. For essentially the same reasons, we have determined that it is reasonable to continue regional rates in this proceeding. At this point, we see no reason to require SCWC to further justify the existing rate structure in the next GRC as recommended by the Water Division. However, we recognize that there may be viable alternatives to regional rates and that subsequent investigation by others may provide a sound basis for altering the current rate structure. If so, any related decisions should be based on a comprehensive analysis and complete record.

For this reason we will require SCWC to continue to provide annual reports on regional rates as ordered and described in D.00-06-075. Those reports should be distributed to all appearances in this proceeding. In the next Region III GRC, parties may raise this issue again, but the burden will be on the parties to demonstrate why the rate structure should be altered as opposed to SCWC having to demonstrate why it should be continued.

In this proceeding, ORA raised specific concerns with the implementation and continuation of regional rates. While ORA's concerns have sound theoretical

bases, there is little evidence or analysis that substantiates the validity and applicability of those concerns specifically with respect to the Region III rate structure. For instance, if the data is available, the potential subsidization of high income ratepayers in high cost districts by low income ratepayers in low cost districts could be objectively analyzed and problems specific to Region III, if they exist, could be demonstrated. Similarly changes in usage patterns by subsidized users and the effect on utility efficiencies could be demonstrated with facts and objective analyses. Such analyses should be the foundation for any proposals to alter the current rate structure.

5. Allocation of GO Costs to Non-GRC Districts

SCWC requests that the General Office (GO) costs adopted in this Region III GRC be allocated to the Region III districts as well as to the non-GRC districts (those districts in Region I and Region II). For the non-GRC districts, SCWC proposes to increase rates only for the incremental allocation of GO costs above the level of GO costs already incorporated into their rates. ORA recommends that SCWC's request be denied because a GO adjustment for non-GRC districts would provide SCWC rate increases for the GO cost twice, GO costs require a thorough review beyond what is given offset costs, and the request goes against the rate case processing plan.

We conclude that SCWC's proposal should be denied. For the non-GRC districts, SCWC's showing neither details the embedded expenses and capital costs for the various test and attrition years, nor explains how such costs should be determined. Also, for capital costs estimated in this GRC, the rate base amounts, net returns and income taxes related to GO plant additions are not separately identified from the non-GO amounts. We therefore cannot determine the reasonableness or accuracy of SCWC's incremental proposal. We will instead

adopt ORA's recommendation that GO recovery should be determined in the GRC for each region. This methodology was used for SCWC, previous to the test year 2000 Region III settlement, and does not depend on incremental changes to GO expenses and capital costs.

6. Allocation of GO and Other Costs to Unregulated Operations

American States Water Company, the parent holding company for SCWC, provides services on an unregulated basis to third parties through its American States Utility Service Company (ASUS) subsidiary. According to SCWC's proposal, a portion of the revenues from the non-regulated operations of ASUS are shared with SCWC's ratepayers as "other revenues" to the utility operation. In its estimate of other operating revenues for Test Year 2003, SCWC includes \$63,400, which represents the ratepayer share of revenues from non-regulated services provided by ASUS. SCWC states that its allocation of revenues from non-regulated services between ASUS and SCWC conforms to the methodology adopted by the Commission in D.00-07-018.⁹

ORA argues that D.00-07-018 does not apply to what SCWC and its unregulated affiliate are doing. In ORA's opinion, if ASUS bears its full share of overhead and common costs as determined by an impartial cost study, nothing more is needed. ORA requests that the Commission order a study to determine the full costs, both expense and capital, incurred by SCWC on behalf of ASUS,

⁹ In that decision, the Commission adopted a revenue sharing proposal for non-regulated service revenues. Revenues from "active" services are allocated on a 10% ratepayers/90% shareholders (i.e., ASUS) basis. Revenues from "passive" activities are allocated on a 30% ratepayers/70% shareholders basis. The designation of activities as either active or passive was shown on Table A attached to D.00-07-018.

presently and in the future. Once completed, SCWC should develop either allocation factors for accounting transfers to the books and records of ASUS or a set of charges to be billed to ASUS and reimbursed to SCWC. Until the study is completed, ORA requests that the Commission suspend the affiliate revenue sharing procedure proposed by SCWC and has included an increase of \$101,300 in GO revenues to reflect the suspension.

This decision concludes that SCWC should follow the policies and guidelines adopted in SCWC's holding company decision, D.98-06-068, regarding affiliate transactions. In order to reflect the principles, policies and guidelines outlined in D.98-06-068, SCWC is ordered to conduct a cost study and analysis that will be the basis for assigning and allocating future costs related to its affiliates. Until then, we will impute a revenue adjustment of \$101,300.

6.1. Discussion

SCWC and ASUS are both subsidiaries of American States Water Company. In dealing with its affiliates, SCWC should be following the procedures and reporting requirements adopted in D.98-06-068, the Commission decision that authorized SCWC to form a holding company structure. In justifying the formation of the holding company, the company stated:

“SoCalWater foresees a variety of opportunities in unregulated businesses including, for example, public/private partnerships with municipalities and other local governmental agencies that could involve long-term lease concessions of water systems, operation and maintenance contracts, and billing and other customer service functions. It may provide such services to other Commission-regulated utilities as well. A holding company structure would separate the regulated utility and thus help insulate customers from these competitive and unregulated business activities without compromising the Commission's oversight and regulatory responsibilities. There would be fewer potential cross-subsidization issues, and SoCalWater would be

better able to tailor its finances and organization to both roles. SoCalWater would continue to make appropriate allocations where, as now occurs from time to time, its personnel engage in both regulated and non-regulated activities, and those allocations would continue to be subject to Commission review to protect ratepayers.”¹⁰

The decision adopted specific policies and guidelines for the various transactions conducted between SCWC, the holding company and affiliates. The overriding theme is that ratepayers should not subsidize affiliate operations. The justification for allowing SCWC to establish the holding company structure and the implementation principles are directly applicable to the issue of allocating costs to unregulated operations in this GRC. SCWC should follow the policies and guidelines adopted in D.98-06-068.

Rather than following the principles and guidelines of the holding company settlement, SCWC has instead used the principles established in D.00-07-018, which established an Other Operating Revenue (OOR) sharing mechanism applicable to water utilities that intend to offer non-tariffed services. SCWC has misinterpreted the intent of that decision. The revenue sharing mechanism is intended to apply to a water utility (1) providing non-tariffed services, (2) sharing the gross revenues with ratepayers, and (3) absorbing all incremental costs. It does not apply to non-regulated affiliates of the water utility. While we regulate water utilities, we have no direct authority over non-regulated affiliates. Rather than imposing a sharing mechanism on the revenues of non-regulated affiliates, we instead attempt to ensure that utility and affiliate

¹⁰ 80 CPUC 2d at 582.

costs are properly separated and common costs are fairly allocated. In that way, sharing of non-regulated affiliate revenues with ratepayers is unnecessary.

Since SCWC is relying on the revenue sharing mechanism adopted by D.00-07-018 to reflect the proper cost reimbursement by ASUS to SCWC, ASUS is only charged on an incremental cost basis. It is therefore apparent that a cost study and analysis, as recommended by ORA, is required in order to fairly assign and allocate costs related to SCWC's affiliates, in accordance with the principles, policies and guidelines outlined in D.98-06-068. We will order such a study to be completed by SCWC and included in its next Region III GRC application. The company must address each point in the holding company decision that applies to affiliate transactions and costs and must show the effect, on both affiliate and utility costs, of implementing the appropriate measures to comply with the terms of that decision. SCWC also must adopt appropriate management policies and accounting practices to ensure that the terms of the holding company decision are fully implemented.

ORA requests that the Commission suspend the affiliate revenue sharing procedure proposed by SCWC, until the cost study is implemented. ORA's adjustment amounts to an increase of \$101,300 in GO revenues. We adopt ORA's adjustment but characterize it as a proxy for potential adjustments that might result from the cost study. Under the circumstances here, where the utility has apparently not been following procedures adopted in its holding company decision, the adjustment is reasonable.

7. Cash Preservation Plan

The Cash Preservation Plan (CPP), implemented by SCWC in early 2001, was designed to limit cash expenditures on capital projects and O&M for its electric and water operations during the energy crisis. SCWC argues that both its

capital and O&M budgets now need to reflect on-going operations, not artificially depressed levels attributable to extraordinary circumstances. SCWC states that the budgets in this application reflect return to normal operations.

ORA recommends that SCWC's revenue requirement be reduced by \$3.6 million for O&M expenses not spent and \$3.2 million for the carrying charge of the capital projects deferred during 2001 and 2002 over the next two years, since SCWC ratepayers were denied the benefit of funds that the Commission approved for those purposes. ORA does not argue that the CPP was unreasonable or unjustified but does oppose customers paying twice for the same O&M expenses and projects.

This decision imposes a reduction to Region III maintenance expenses in the amount of \$352,000 for both test year 2003 and 2004. Without such an adjustment, shareholders will receive a windfall due to deferral of expenditures and recovery of electric energy costs through balancing account treatment.

7.1. Background

The CPP was implemented in response to a deterioration in SCWC's cash flow due to escalation in energy prices in California beginning in 2000. While the price of electric energy escalated dramatically, rates to SCWC's electric customers remained unchanged. As a result, SCWC substantially under-collected those costs through revenue and accrued those under-collected costs in a balancing account. Between December 1999 and June 2002, SCWC paid out over \$25 million more in electric power costs than was recovered in customer rates.

SCWC consciously made the decision to preserve cash intended for water operations in order to pay the electric bills of its Bear Valley Electric District (BVE). BVE customers, SCWC water customers and shareholders provided the cash for that purpose. Since the energy-related revenue shortfalls were afforded

balancing account treatment, recovery of appropriate energy costs for BVE will be addressed in BVE proceedings and BVE customers will eventually pay for the 2001 and 2002 energy revenue shortfalls through whatever mechanism is adopted in the energy company proceedings.

The CPP included measures such as a hiring freeze, reductions in operating expenses, and elimination or deferral of all capital projects except for those projects that were considered essential either to meet public safety and health requirements or to provide continued service.¹¹

7.2. Discussion

BVE purchased energy costs were in part paid by SCWC water customers. Through the balancing account procedure for costs incurred in 2001 and 2002, BVE will eventually be made whole for the reasonable amount of purchased power costs. Water customers should therefore be reimbursed, in some manner, for the cash that was diverted from the water operations for those years. To do otherwise would result in a windfall for shareholders. This is explained below.

The BVE purchased energy costs were paid to energy providers during 2001 and 2002. The balancing account then tracked the money that would eventually be repaid to whoever put the money up at that time. As revenues are collected to offset the balancing account expenses, they will not be used to actually pay the purchased energy costs but to reimburse those who put up the

¹¹ In its testimony, SCWC shows that in 2001 its capital budget was \$52 million and actual capital expenses were \$39 million. For 2002, the budget was \$56 million and the recorded amount was approximately \$45 million. In 2001 maintenance expenses on a company wide basis were \$2 million less than budgeted. Also for the first 6 months of 2002, the gap between budgeted and recorded was \$2 million, and as a part of the CPP, SCWC implemented a hiring freeze in 2001, holding the employee count at its February 2001 level.

money in 2001 and 2002. The cash to pay for the energy purchases in 2001 and 2002 came from three sources. First, cash was available from the BVE ratepayers, through electric rates at that time. Second, cash derived by deferring expenses and capital projects related to the water operations was used to offset a portion of the revenue shortfall. Third, cash to offset any remaining shortfall would have come from shareholder funds. Therefore, while the water operations and shareholders funded a portion of the revenue shortfall,¹² unless specific provisions are made, as money accrues to the balancing account to offset that portion of the shortfall, all of those revenues will accrue to shareholders. It is reasonable to return an appropriate amount as offsets to costs of the water operations.

Since this GRC addresses rates for Region III only, we will only consider the effects of the CPP on Region III in this decision. Affected expenditures, as indicated by SCWC, include maintenance expenses, operating expenses, A&G expenses and capital related costs. Regarding capital costs, SCWC indicates that its general policy is to hold capital spending within Commission-adopted amounts, and that, based on its internal budgets, it deferred a substantial amount of capital expenditures in 2001 and 2002. Nevertheless, the recorded additions for those years are slightly higher than authorized in the previous GRC

¹² Electric customers also funded a portion of the shortfall through cash derived from deferred expenses and capital projects. The consequences, if any, should be addressed in BVE rate proceedings.

decision;¹³ thus, it appears that, in this GRC, ratepayers are not paying for capital projects that were deferred from the last GRC.

This does not appear to be the case for O&M. The long-term effects of deferred spending, especially in the area of maintenance, are hard to quantify, but deferrals of necessary expenditures jeopardize the efficient operation of the utility's system and may result in higher long-term costs. For instance, the testimony of SCWC's District Managers indicates that over time the company has under spent for maintenance even though it generally spends what the Commission authorizes for such purposes,¹⁴ that the deferral of maintenance expenditures could have certain long-term effects on the operation of the system, and that the proposed GRC maintenance expense amounts include items deferred from previous years.¹⁵

In considering reimbursement for Region III, we will assume that the amount that should eventually flow back to those water ratepayers is the difference between what should have been spent for maintenance for 2001 and 2002 and what was actually recorded for those years. We could have based the adjustment on the difference between what was previously authorized and what was spent, but the record does not establish previously authorized amounts and we have some concern regarding deferred maintenance as discussed above. Recorded maintenance costs for Region III are listed below.

¹³ SCWC states that its internal capital budgets included \$52 million for 2001 and \$56 million for 2002. Recorded amounts were \$39 million for 2001 and \$45 million for 2002 while the authorized amounts were \$37 million and \$42 million, respectively.

¹⁴ See transcript 438-433 Perry Dahlstrom.

¹⁵ See transcript 451-453 Patrick Scanlon.

Region III Recorded Maintenance Expense

<u>Year</u>	<u>Labor</u>	<u>Non Labor</u>	<u>Total</u>
1997	\$ 936,200	\$1,608,200	\$2,544,400
1998	1,030,000	1,934,800	2,964,800
1999	1,076,500	2,989,800	4,066,300
2000	1,131,300	2,657,700	3,789,000
2001	1,034,500	1,773,300	2,807,800
2002	1,122,100	2,185,700	3,307,800

To determine what should have been spent in 2001 and 2002 on maintenance, we assume the 2003 maintenance expense forecast of \$3,689,000 that is included in the Stipulation is reasonable. We also assume that 2001 and 2002 were not normal spending years due to the energy situation and that the amounts not spent in 2001 and 2002 were used to offset increased energy procurement costs for BVE customers. We also assume that a reasonable estimate of what would normally have been spent in 2001 (absent the energy crisis) is the 2003 stipulated amount deescalated to 2001 dollars, or \$3,556,100. Similarly, a reasonable estimate for 2002 is the 2003 stipulated amount deescalated to 2002 dollars, or \$3,616,200. When compared to recorded amounts, the difference is \$748,300 for 2001 and \$308,400 for 2002 or \$1,056,600 in total. We will amortize that amount over this GRC cycle at \$352,200 per year as a reduction to the ratepayers' obligation to fund maintenance expenses. The stipulated maintenance expenses will be funded partially by shareholders who will be receiving money to do so through the BVE balancing account recovery mechanisms. We will not make further adjustments for the apparent deferral of expenses related to operating expenses and A&G expenses. Of the three expense categories, maintenance has the largest deferral amount. Our adopted

adjustment is not precise and we will assume that the result also covers operating and A&G deferrals.

SCWC claims that all deferred O&M expense projects will have been completed by the end of the current rate case cycle. However, if the “current rate case cycle” is the currently authorized 2000-2002 cycle, the record does not support that statement. Based on its own testimony, SCWC underspent in both 2001 and 2002. If the “current rate case cycle” is the 2003-2005 cycle being considered in this proceeding, we would have concerns about recovery of deferred maintenance in subsequent rate cases, as expressed in D.82-12-085 regarding a Southern California Edison Company GRC.¹⁶ In that decision, the Commission disallowed deferred maintenance costs for ratemaking purposes but did not relieve the company of its responsibility to maintain the operating efficiency of its utility plant in a timely manner. SCWC’s claim regarding completion of deferred projects is not persuasive.

8. Earnings Test

For the earnings test used to justify step and attrition rate increases, ORA proposes a change whereby the weather-adjusted recorded sales per customer for Residential and Commercial customers would be used, instead of the adopted sales per customer, for the calculation of the revenues. ORA states that originally, the procedure was designed to normalize sales against sales changes due to weather variations. However, because of the difficulty and time involved in the weather normalization process, adopted sales quantity has been used and, in reality, weather normalization is not being done. Under ORA’s proposal,

¹⁶ See 10 CPUC 2d at 184-186.

when the utility is over-earning (the actual earnings are higher than the adopted earnings) because of inaccurate adopted sales, the step and attrition rate increases would be reduced or eliminated through the earnings test, protecting the ratepayers from unnecessary rate increases.

In response, SCWC asserts that under existing procedures, pro-forma revenues for residential and commercial customers are based on adopted sales per customer, not weather-adjusted recorded sales per customer, and that ORA's recommendation is inconsistent with long-standing procedures for the pro-forma earnings calculation. SCWC believes ORA is inappropriately attempting to use SCWC's GRC to implement changes to industry-wide policy.

This decision denies ORA's request and concludes that the issue would be more appropriately addressed in a generic proceeding where all affected utilities could participate.

9. Attrition

SCWC states that an unintended consequence of agreeing to advice letter procedures for certain capital projects, as reflected in the Stipulation, is that exclusion of the advice letter projects from authorized rate base negatively impacts the calculated attrition increase for 2005 by reducing the capital additions covered by the attrition increase. SCWC proposes that for the purpose of calculating the attrition year increase, the weighted average rate base for 2003 and 2004 should include advice letter projects.

ORA argues that SCWC's proposal would result in double recovery of the cost of those advice letter projects, once through the attrition rate increase, and again, through an advice letter rate increase. SCWC claims its proposal would not result in double recovery, but would simply allow SCWC to maintain in 2005 a level of capital improvements similar to that stipulated to for 2003 and 2004.

Due to the manner in which the proposed advice letter projects are considered in this decision, we will not adopt SCWC's proposal.

9.1. Discussion

By this decision, SCWC is authorized to accrue the costs of the Calipatria treatment plant project in a memorandum account and seek rate recovery either through a separate application or in the next GRC for Region III. This is a large project in the range of \$10 million to 18 million. It is not reasonable to reflect its effect in the attrition calculation. Projects of this magnitude must be evaluated based on the need and costs of the particular project. Rate recovery should not be accomplished through the attrition mechanism.

By this decision, the remaining proposed advice letter projects are treated as normal plant additions and are estimated as such. Due to the uncertainty of the timing of the projects, this decision assumes that, on average, the operational date for the projects is January 1, 2005. An allowance for the attrition year is therefore already included for these projects.

10. Water Quality Memorandum Accounts

SCWC seeks memorandum account treatment for costs to comply with five specific water contaminants. The five contaminants are MTBE,¹⁷ perchlorate, NDMA¹⁸, radon, and arsenic. The water industry has seen a tremendous expansion in the number of water contaminants over the last 20 years, many of which have had a significant negative impact upon water supplies throughout California. The expense associated with building new treatment facilities to

¹⁷ methyl tertiary butyl ether

¹⁸ N-nitrosodimethylamine

comply with maximum contaminant levels (MCLs) adopted for emerging contaminants is high and can involve complex treatment methodologies and significant lead time (design, bidding, construction) prior to completion. SCWC states that, in the past, it has included costs associated with anticipated MCLs, but when these costs are included in capital and O&M budgets in applications, they have been rejected by ORA, because the MCLs are not final, or have a long compliance period and/or are subject to change.

ORA argues that SCWC's request for Water Quality Memorandum Account should be denied because SCWC is requesting blanket memorandum account, before specific rules become effective. Absent such rules, there would be uncertainty about which costs would be charged to the memorandum account. ORA recommends instead that SCWC be allowed to file an advice letter when such water quality rules become effective.

SCWC notes that when the Commission authorizes creation of a memorandum account, it only allows for the recordation of certain costs in that account. Before a utility can recover in rates the costs recorded in the account, the utility must demonstrate the reasonableness of the costs. SCWC indicates that its request is no different – it seeks only the creation of various water quality memorandum accounts, so that it may book, or record, its costs in those accounts. When SCWC seeks to recover the costs, it will apply to the Commission to do so, and will demonstrate the reasonableness of those costs.

We grant SCWC's request for memorandum account treatment for costs to comply with requirements related to the five specified contaminants.

10.1. Discussion

Costs to mitigate water contamination are difficult to forecast until the appropriate regulator specifies the associated requirements. The requirements

determine both the magnitude and the timing of expenditures. Establishing such requirements is out of the utility's control, and a memorandum account procedure is a reasonable way to deal with the problem. We also agree with SCWC's characterization of the memorandum account procedure. We therefore authorize the account as requested by SCWC.

The related utility expenditures would include capital costs, O&M costs, monitoring costs, legal costs and consultant costs associated with activities to mitigate the effects of the five specified contaminants. The costs booked to the memorandum account must be the incremental capital costs and expenses. We emphasize incremental. The utility must be able to demonstrate that existing rates do not directly or indirectly already include consideration for the recovery of these costs. If they do, the utility must be able to show that appropriate consideration of those costs was given in determining what the incremental costs in the memorandum account should be. For instance, for arsenic, the MCL may be substantially reduced in the future. There may then be increased costs related to the tougher MCL requirements. Before the costs of any new program are recovered in rates through the memorandum account, the utility must demonstrate that the requested costs are truly incremental. They should be net of any previously recovered costs related to the old MCL activities replaced or augmented by the new MCL activities. The utility should clearly describe in its preliminary statement which costs it plans to book.

We intend that ongoing costs eventually be reflected through the GRC process, at which time the accumulated balance and proposed recovery can be examined. Until then, the memorandum account would accumulate the associated costs.

11. Water OII Amortization

In 1998, the Commission issued Resolutions W-4089, W-4094 and W-4257, authorizing the establishment of memorandum accounts for the Water Quality OII (I.98-03-013) and water quality litigation expenses. While the water quality lawsuits are still active, a final decision in the OII was issued by the Commission on November 2, 2000. The Commission concluded that the California Department of Health Services (DHS) requirements governing drinking water quality adequately protect public health and safety, and that regulated water utilities, including SCWC, have satisfactorily complied with past and present drinking water quality requirements. SCWC seeks in this proceeding to amortize the balance of the OII expenses. The current balance as of March 31, 2003 is \$1,052,480 as shown in Schedule 4 of Exhibit 37.

SCWC seeks to amortize the Water Quality OII portion of the memorandum account through a special condition surcharge over a 12-month period, applied to the quantity rate throughout the company. Based on the current balance, the surcharges for each CSA are shown in Schedule 4 of Exhibit 37. ORA does not oppose SCWC's request, and we will grant it.

12. Water Quality Compliance

In Schedule 2 of Exhibit 31, SCWC has presented its water quality compliance record from March 1998 to December 2002, updating the data presented to the Commission in the Water Quality OII. SCWC seeks a finding from this Commission that it is in compliance with present drinking water standards and water quality regulations.

In its report for the update period, SCWC has provided instances of noncompliance with drinking water standards, instances the drinking water standards were exceeded, number of citations from the DHS, corrective measures

taken to comply with regulations and corrective measures related to 10-day letters of compliance. However, whether this information is complete and accurate and whether it warrants a finding that SCWC remains in compliance with applicable drinking water standards and water quality regulations needs to be verified, preferably by the DHS. No such verification has been established in this proceeding. For this reason, we cannot make the finding as requested by SCWC.

13. Lease of Water Rights to the City of Folsom

In November 1994, SCWC signed a contract to lease, to the City of Folsom, 5,000 acre-feet per year (AFY) of water rights to the American River and has included all associated revenues in a non-operating revenue account. Staff asserts that SCWC was imprudent in signing the lease and was negligent in not filing an application under § 851 for Commission approval of the lease. Staff recommends the lease be voided, SCWC be fined \$180,000, SCWC's rate of return be reduced by 50 basis points, lease proceeds be booked to an operating revenue account, all recorded lease proceeds from 1996 – 2003, plus interest, be credited to ratepayers and SCWC be ordered to file certain water supply and demand information. This decision assigns all lease proceeds from the year 2003 forward to an operating revenue account, which will be used in the determination of the revenue requirement for the Arden-Cordova CSA. The other ORA recommendations are not adopted.

13.1. Procedural Background

Issues related to the 1994 lease were raised by ORA in the test year 2001 GRC (A.00-03-064) for SCWC's Region I, which includes the Arden-Cordova CSA. In that proceeding, the Ratepayer Representation Branch (RRB) contended that SCWC violated § 851 when it entered into its 1994 agreement with the City

of Folsom. Staff recommended that the Commission order SCWC to return all revenue collected from the leasing of water rights since 1994 to the customers and order SCWC to file an application requesting Commission authorization of the contract.¹⁹ Subsequently, SCWC issued rebuttal testimony on this issue. RRB and SCWC eventually settled the GRC; and, as part of the settlement, the parties agreed to defer the lease issue to a proceeding in early 2001.²⁰ That proceeding was to be the GRC for Region II. The Region II GRC was not filed as anticipated at the time of the settlement. Instead, the next GRC filed by SCWC is the current Region III GRC. Therefore, ORA, the staff advocacy successor to RRB, has raised the lease issue in this proceeding, and SCWC has again rebutted the related staff testimony.

13.2. Factual Background

The facts contained in the following background discussion are not in dispute.

In June 1964, SCWC purchased the Natomas Water Company. With the purchase, SCWC obtained 32,000 acre-feet per year (AFY) of water rights to the American River. Subsequently, by D.71889 issued January 24, 1967, the Commission authorized SCWC to transfer the Folsom water system and 22,000 AFY to the City of Folsom

From 1966 to 1970, SCWC used approximately 500 AFY of raw, untreated water from the American River for irrigation customers in Rancho Cordova.

¹⁹ See Exhibit 14-A, p. 7

²⁰ See Section 6.01 of the Settlement attached as Appendix B to D.00-12-063.

SCWC had no facility to treat surface water after the City of Folsom acquired the Folsom Treatment Plant.

SCWC constructed the Coloma Treatment Plant (operational in 1973) to treat surface water. The plant and system that was recorded in SCWC's rate base could treat and distribute only 5,000 AFY of SCWC's entitlement to American River water. Attached as Exhibit B to Exhibit 38 is a chart detailing SCWC's actual surface water production from the American River from 1973 through 2002. The chart shows that SCWC's use of surface water from the American River was as low as 678 AF in 1973, gradually increasing to 3,451 AFY by 1990.

In November 1994 SCWC signed the lease with the City of Folsom. At that time, SCWC had never used more than 3,451 AFY of surface water from the American River to serve its customers. Lease revenues received by SCWC have been booked in PUC Account 526, Miscellaneous Non-Operating Revenues. Since this is a below-the-line account, all revenues have benefited shareholders.

In 1994, groundwater was plentiful and it was cheaper for customers to be supplied by groundwater than by American River surface water, which had to be treated at the Coloma Treatment Plant before it could be delivered to customers. At that time, it cost approximately \$56.73 per acre-foot to deliver potable water from the Coloma Treatment Plant (American River surface water), compared to only \$37.10 per acre-foot to deliver potable water from SCWC's groundwater wells in its Cordova system. The total power and chemical cost for the two sources of water is virtually identical, but the labor cost associated with operating the Coloma Treatment Plant made using surface water more expensive.

Also in the 1994 timeframe, while a few wells had begun to show traces of TCE²¹ contamination, SCWC had successfully installed granulated activated carbon filters on the wells to remove TCEs. SCWC did not discover that there were detectable levels of perchlorate in its groundwater wells until 1997, and did not discover the presence of NDMA in its wells until 1998. All of SCWC's groundwater wells were fully operational until 1997, when the utility discovered the perchlorate contamination. Since 1997, SCWC has taken out of service 11 wells due to the contamination.

To address water supply problems, SCWC has placed into operation several new groundwater wells that were drilled in locations away from the contamination and has constructed new treatment capacity at its Coloma Treatment Plant. In the short term, SCWC plans on using 10,000 AFY of untreated water obtained in a "take or pay", five-year contract with the Sacramento Municipal Utilities District (SMUD). The contract became effective July 29, 2002.

13.3. Discussion

There are three principal issues related to the lease. The first is the prudence of SCWC's decision to lease 5,000 AFY of water rights to the City of Folsom, beginning in 1995. The second is whether SCWC should have filed an application, under § 851, to request Commission authorization to effectuate the lease. The third concerns the proper ratemaking treatment for revenues received from the lease of the water rights.

²¹ Trichloroethylene

In general, for cases related to the transfer or encumbrance of utility property, where there are potential issues such as management reasonableness, the useful and necessary criteria and allocation of the benefits, it would be preferable for the utility to file a § 851 application for our determination, even if a strict interpretation of § 851 indicates that a filing is not necessary. Absent such a filing, the utility puts itself at risk for the transaction being voided, penalties being imposed, and refunds or other ratemaking adjustments being ordered. In this particular proceeding, ORA has raised significant, relevant issues related to the lease of SCWC's water rights to the City of Folsom and the company's decision not to seek Commission authorization for the transaction. The fact that we are addressing these concerns now rather than in 1994 when the transaction was contemplated is due to the actions of SCWC.

Regarding the prudence of the lease, our standard is that the determination of prudence or imprudence should be based on what was known or should have been known at the time the decision to act was made. That standard is also fair and appropriate in this case where we are evaluating specific actions of SCWC's management and considering sanctions related to those actions.

Unfortunately, much of what ORA argues in this case appears to be based on hindsight, not conditions as they existed at the time SCWC entered into the 1994 lease. For instance, ORA points to the need now for the water rights since groundwater contamination has reduced the availability of pumped water. For a prudence review, information that was known, or should have been known, in 1994 regarding such factors as the existing contamination, the potential for treating that contamination, the potential for finding other contaminants and the potential for stricter regulations should be analyzed to determine whether SCWC could have and should have anticipated the magnitude of the present contamination

problem and the need for the water rights. Similarly, regarding growth of the system, the ORA assertion that water leased to the City of Folsom is now needed to serve the Arden-Cordova CSA is based on information much of which is subsequent to the signing of the 1994 lease. The more compelling evidence as to the prudence of the company's actions would include information related to long term water demand forecasts conducted in the 1994 timeframe and the supply mix options, considered in that same timeframe, that would satisfy the long term water demand. Considering the weight of the evidence in the record, we cannot conclude that SCWC management acted imprudently when it signed the 1994 lease, and we will not impose a rate of return penalty as requested by ORA.

While we do not find that SCWC acted imprudently, the responsibility for signing the discretionary lease falls on the utility; and, as such, the responsibility for effectively addressing any adverse consequences of that discretionary action also falls on the utility. It is therefore appropriate to explore all options to alleviate any negative effects of that transaction. Also, the resolution of the prudence issue is independent of the resolution of the issues concerning whether SCWC should have filed a § 851 application, to which we now turn, and the proper ratemaking treatment for lease revenues.

The issue of whether SCWC should have secured authorization from the Commission, under the provisions of § 851, before leasing the water rights to the City of Folsom, depends on whether these water rights were "useful or necessary in the performance of its duties to the public." SCWC makes the point that up to 3,451 AF per year of the available 10,000 AF per year of water rights had been used to the point in time when the lease was signed, so the 5,000 AF leased to the City of Folsom had never been used. Those are established facts in this case. ORA has also established that SCWC now needs more water rights, in fact its

entire allocation of 10,000 AFY to replace capacity of the to shut-down wells. In this instance, the American River water rights, in part and ultimately as a whole, are useful and necessary to provide service to the Arden-Cordova customers. However, for determining the necessity, in 1994, for SCWC to file an application under the requirements of Section 851, the positions of the parties indicate we need to clarify whether water rights can be viewed in pieces in the “necessary and useful” analysis and clarify what “necessary and useful” means for the purposes of § 851.

As to whether water rights can be viewed in pieces, we agree with SCWC, based on the facts in this case. The original 32,000 AFY in water rights obtained by SCWC from the Natomas Water Company in 1964 were separable in that 22,000 AFY were subsequently included in the sale of SCWC’s Folsom System to the City of Folsom in 1967. We see no reason why portions of the remaining 10,000 AFY should not also be considered separable for purposes such as sale or lease. Also, the record shows that at least 5,000 AFY were not being used and were not necessary in 1994. Therefore, we conclude that, in 1994, 5,000 AFY were not necessary or being used in the operation of the Arden-Cordova CSA.

There is precedent for a utility not being required to file an application under § 851 when transferring utility property.²² The criterion was whether the property was presently necessary or useful at the time of the transfer. ORA did not cite any Commission decisions that contradict this criterion. However, we note that it is common for utilities to file § 851 applications when selling land and

²² See, e.g., D.82-12-121, 10 CPUC 2d at 657 (electric utility could sell coal properties without Commission authorization after utility cancelled plans for coal-fired power plant; however, Commission could allocate, as between ratepayers and shareholders, proceeds of the sale).

buildings that are no longer useful or necessary. Whether the property is, or is not, useful or necessary can be confirmed and the disposition of any gains or benefits can be determined by the resulting decision. As indicated previously, our preference would be for SCWC to have filed a § 851 application in 1994 and we would encourage utilities to do so in the future. However, a strict reading of § 851 favors the position of SCWC, and we conclude that SCWC was not required to file an application pursuant to § 851 when it leased the water rights to the City of Folsom. We will therefore not penalize the company or void the lease as recommended by ORA.

We now turn to the ratemaking issue. In the past we have allocated net benefits from the transfer or encumbrance of utility property to ratepayers, to shareholders or to both based on circumstances and assessments of risk. Also as we indicated earlier in determining that while SCWC did not act imprudently when entering into the lease agreement, the utility is still ultimately responsible for the decision to do so. To the extent possible, the associated risks should not fall on the ratepayers. In this case, due to the length of time that has passed since November 1994, when the lease was signed, we have substantial knowledge related to the effect of the lease historically as well as prospectively. It was not until 2002 that SCWC required more than 5,000 AF of surface water, as evidenced by the SMUD agreement. Up until this time, ratepayers were apparently not harmed by SCWC's decision to lease the water rights. However, it is from this point forward that the Arden-Cordova CSA need for the water rights leased to Folsom becomes apparent. By the five-year water transfer agreement with SMUD, SCWC has annual access to as much as 10,000 AF of water for the time period July 2, 2002 through July 29, 2007. Costs related to the SMUD agreement will be borne by ratepayers. Beyond that time period, it is not certain or clear

how SCWC will obtain its water supply for the Arden-Cordova CSA. In whatever manner it is accomplished, ratepayers will again, in all likelihood, be expected to shoulder the related costs. It is from this point, sometime in late 2002, that ratepayers are substantially exposed to the negative effects of the lease. The first full-year of these effects would be 2003.

SCWC argues that the water rights were never in rate base, are non-utility/non-regulated property of SCWC and therefore the lease proceeds should accrue only to shareholders. We do not accept that proposition. When SCWC purchased the Natomas Water Company in 1964, the transfer of water rights was included in the transaction. As even SCWC admits, certain amounts of those rights were exercised previously by the Natomas Water Company and subsequently by SCWC. The fact that certain amounts of the water rights were not necessary or useful at a certain point in time may be relevant in determining whether or not a § 851 application is necessary when selling or leasing those rights. However, that fact is not relevant in determining whether those rights are, or are not, utility property. In fact, evidence in this proceeding shows that the leased water rights are now necessary and would be useful to the ratepayers, were they not already encumbered by the lease.

In this case, the entire cost the Natomas Water Company purchase, which included 32,000 AFY was borne by the ratepayers. Shareholders were not separately responsible for recovery of any of the costs. We see no reason to assign the benefit of the water rights to shareholders merely due to the fact that as SCWC states, “At that time – 1963 – it was common practice to attach no monetary value to water rights and therefore SCWC acquired these water rights

for free.”²³ That is insufficient reason to make such an assignment. We determine that the entire amount of water rights was utility property at the time of the purchase and the entire, currently remaining, 10,000 AFY, which includes the 5,000 AFY being leased to the City of Folsom, continues to be utility property.

Based on this risk assessment, it is reasonable to allocate the benefits of the lease to shareholders from inception until the end of 2002 and allocate the benefits to the ratepayers beginning in 2003, for the duration of the lease. Lease revenues should substantially offset the negative short and long term effects of the lease in the same timeframe that those negative effects will occur. Therefore, beginning in 2003, revenues derived from the 1994 lease of water rights to the City of Folsom should be booked to an operating revenue account.²⁴ Those revenues should be used to offset water production costs for the Arden-Cordova CSA. Based on the circumstances of this case, we feel these actions fairly address the concerns that have been raised. The result is preferable to either the company or ORA proposals where either shareholders or ratepayers would receive the entire lease benefit.

Since this decision allocates pre-2003 lease revenues to shareholders, we will not adopt ORA’s recommendations to fine SCWC \$20,000 for each year it failed to record the revenues from the lease of the water rights in PUC account 607, and to order SCWC to return all revenues collected from the lease of water

²³ SCWC Opening Brief, p. 19.

²⁴ ORA recommends the use of PUC account 607. However, that account pertains to billings for water supplied to governmental agencies, not to lease contract proceeds. Proceeds from the lease contract should be booked to account 614, other water revenues, which includes revenues derived from water operations not includable in any of the other operating revenue accounts.

rights contract with the City of Folsom since 1994, plus 7 % interest, to the Arden-Cordova CSA's customers.

Also, at this time, we do not feel it is necessary to order SCWC to provide the supply, demand, and cost studies recommended by ORA. These considerations, to insure adequate water supply for the Arden-Cordova water system, can be addressed in the next Region I GRC, at which time SCWC will have the burden of proof to justify its expenses and capital expenditures related to water supply and production.

COST OF SERVICE ISSUES

14. Cost of Capital

SCWC requests a rate of return on rate base of 10.15% for each of the years 2003, 2004 and 2005. ORA recommends the Commission adopt a rate of return on rate base of 8.54% for 2003, 8.52% for 2004 and 8.55% for 2005. In determining the proposed rates of return, both parties recommend adoption of a capital structure composed of 50% long-term debt and 50% equity. SCWC recommends a cost of debt of 7.8% and a return on equity of 12.45% for 2003, 2004 and 2005. ORA recommends a cost of debt of 7.67% for 2003, 7.63% for 2004 and 7.68% for 2005 and a return on equity of 9.41% for each of the years.

As discussed below, we adopt an average cost of debt of 7.67% in 2003, 7.63% in 2004 and 7.68% in 2005 and a return on equity of 9.90% for each of the years. This equates to a rate of return on rate base of 8.79% for test year 2003, 8.77% for 2004 and 8.79% for attrition year 2005.

14.1. Cost of Debt

SCWC derived its cost of debt by calculating the embedded cost of debt currently outstanding and the projected cost of new debt issues. SCWC derived a coupon rate of 8.00% for new debt issues by adding a spread of 150 basis points

to the Blue Chip Financial Forecast of long-term treasury yields. The 150 basis point spread is an amount consistent with current spreads for an “A+” rated utility issue. To the 8.00% coupon rate for new debt issues, SCWC added 13 basis points to approximate the annual cost factor for issuing new debt, to arrive at a cost of new debt equal to 8.13%.

Once both the embedded cost of debt and the cost of new debt were calculated, SCWC adjusted the embedded cost of debt yearly to reflect reductions in debt due to sinking fund payments, maturities, and projected new debt issues. Accordingly, SCWC derived an estimated, effective cost of long-term debt for 2003 through 2005 of 7.77%, 7.83%, and 7.84%, respectively.

ORA updated the forecast used to determine the coupon rates, using the most recent DRI forecast. Table 5-1 in ORA’s testimony shows its resulting forecast of the new issue coupon rate to be 6.63% for 2003 and 8.47% for 2005. The associated effective interest rates are shown to be 6.76% for the 2003 new issue and 8.62% for the 2005 new issue. ORA’s resulting forecast of the average cost of debt is 7.67% in 2003, 7.63 in 2004 and 7.68 in 2005.

We reject SCWC’s contention that ORA did not account for the issuance costs of new debt. As described above, ORA increased its forecast of the 2003 new issue coupon rate of 6.63% to an effective rate of 6.76% (13 basis points) and increased its forecast of the 2005 new issue coupon rate of 8.47% to an effective rate of 8.62% (15 basis points). This methodology is similar to SCWC’s where it took the forecasted coupon rate of 8.00% for 2003 and 2005 and increased it by 13 basis points to derive the effective rate of 8.13%, for both years. Since ORA’s forecast incorporates more recent information, to which SCWC does not object, we will adopt ORA’s forecast of average long-term debt costs for the period 2003-2005.

14.2. Return on Equity

SCWC requests a return on equity of 12.45 percent. The utility performed four common equity market cost analyses, followed by three book value return on equity analyses. SCWC derived a market cost estimate of 10.87% by averaging costs indicated by the Ibbotson CAPM Method (11.98%), the Fama-French Three Factor Model (10.80%), the Risk Premium (RP) Analysis (10.89%) and Discounted Cash Flow (DCF) Model (9.81%).

After deriving the market-required return rates on market price of SCWC's equity, SCWC then converted those rates to "book value" equivalent return rates. SCWC asserts that a return based strictly on market prices is applicable directly to book value only if the price to book value ratio is already 1.00. Since its current market to book ratio is about 1.9, SCWC used three methods to make the book value conversion. SCWC's conversion of the DCF market cost results in a book value return on equity of 11.10%. The use of the Modigliani & Miller Conversion of Market Leveraged Cost results in a return of 11.58% and the Brigham Leverage Curve-Based Conversion results in a return of 11.66%. The average of the three methods is 11.45%.

To its estimated book value return on equity of 11.45%, SCWC added 10 basis points to account for incremental business risk resulting from return variability, market capitalization, customer mix, capitalization size shortfall and other specific risks. SCWC asserts that water utilities, being the most capital intensive of the utilities as well as the smallest, are particularly susceptible to the risk phenomena of combined forms of leverage and small size. In addition, SCWC added 90 basis points to its required book value return on equity to account for the risks created by the Commission's issuance of Resolution W-4294 and D.03-06-072 in the balancing account OIR.

ORA's 9.41% return on equity is derived from a quantitative analysis using two financial models, DCF and RP, to estimate investors' expected return on equity for SCWC. ORA applied both models to a group of comparable water utilities. The DCF model projected returns on equity of 8.00% based on the 3-month dividend yield, 8.00% based on the 6-month dividend yield, and 7.99% based on the 12-month dividend yield, with an average of 8.00%. The RP model combined average equity risk premiums with average interest forecasts for the test period (years 2003 to 2005). Based on the average 10-year risk premiums, ORA calculated an expected return on equity of 10.59% for the 10-year Treasury bond yield and 10.90% for the 30-year Treasury bond yield. Using the 5-year average risk premium produced expected returns of 10.70% for the 10-year Treasury bond yield and 11.12% for the 30-year Treasury bond yield. Averaged together, ORA calculated an average ROE of 10.83% based on the RP model. Averaging the results of the two financial models produces ORA's expected return on equity of 9.41%.

As discussed below, we have developed a return on equity range and determined that the 9.9% midpoint value of that range will provide SCWC an appropriate return on equity for the years 2003 through 2005.

14.3. Return on Equity – Discussion of Models

The differences in return on equity recommendations between SCWC and ORA are caused by (1) SCWC's adjustment to the model results to convert from a market basis to a book value basis, (2) SCWC's use of two additional financial models, (3) differences in the financial model assumptions and inputs, and (4) SCWC's adjustments to reflect additional risk. This section discusses the first three items

Regarding SCWC's position that it is inappropriate to compare book value returns with market derived returns, it is not clear that the adjustment or the magnitude of the adjustment proposed by SCWC is reasonable or necessary. SCWC's use of the market to book conversion raises its equity return recommendation from 10.87% to 11.45%, or 58 basis points. ORA argues plausibly that the current high market to book ratios for regulated water companies indicate that authorized returns should actually be lowered rather than raised. More importantly, we must recognize that comparisons and averaging of DCF and RP results have been the basis for many of our decisions regarding equity return levels. These past Commission authorized returns have not included SCWC's proposed adjustment. SCWC has not demonstrated, based on its financing experience, or any other practical criteria why the adjustment is necessary at this time. We are reluctant to make a make a major change such as this without convincing evidence supporting the necessity for the change. We will therefore not include the market to book conversion in determining a reasonable equity return. This treatment and the return on equity that we are authorizing today are in line with recent authorizations for other Class A water companies.

SCWC argues that an additional premium is necessary in factoring risk, because small companies are at greater risk than large companies. Specifically, in its CAPM analysis, SCWC uses a small company premium, which is calculated using data from the 2001 Ibbotson Associates SBBI yearbook. The data include all stocks listed on the New York Stock Exchange, American Stock Exchange, and the NASDAQ. The vast majority of the companies on these exchanges are non-regulated and non-water. The Commission has stated that water utilities should not be compared to companies in other industries (D.01-04-034, *mimeo.* at p.13-14;

D.90-02-042, *mimeo.* at p. 38.) As stated in D.92-01-025, “[d]ue to the revenue recovery mechanisms in place for water utilities, we find that water utilities do not face the same overall risks as energy and telecommunications utilities.”

Therefore, for the determination of a reasonable range for equity returns we will not rely on the CAPM, nor will we use the Fama-French Three Factor Model, which appears to be similar in many respects to the CAPM.

The financial models we will consider are the DCF and RP models, both of which have been used in the past by the Commission in determining equity returns for Class A water utilities. Also, both models were run by ORA and SCWC, although there were significant differences in the results.

In its prepared testimony analysis, ORA did not include Artesian Resources as one of the comparable companies. In response to SCWC’s criticism for the omission, ORA reran the DCF and RP models the same way they were run for its report, with the inclusion of Artesian Resources. Based on numbers provided during evidentiary hearing,²⁵ if Artesian Resources were included in the comparable group, ORA’s DCF analysis would yield a return of 8.35% and the RP analysis would yield a return of 10.52%. The average of the methods would be 9.43%, two basis points higher than ORA’s recommended value of 9.41%.

In many of our decisions we have defined a reasonable range for equity returns. The authorized return would fall somewhere within that range. Model results for both ORA and SCWC show a wide range of equity returns. ORA’s original analysis resulted in an 8.00% result from its DCF model, and a 10.83%

²⁵ ORA/Wilson, RT 571, 573.

result from its RP model – 283 basis points apart, or a recommended average that is 17.6% higher than the DCF result, and 13.1% lower than the RP result. SCWC asserts that this large disparity of 283 basis points between the DCF and RP results makes the ORA analysis unreliable. With the inclusion of Artesian Resources in the comparable group, ORA's spread between the DCF and RP model results would be reduced to 217 basis points. In its market cost of equity analysis, SCWC shows a range from 9.81% to 11.98%, or 217 basis points. The spread between SCWC's DCF (9.81%) and RP (10.89%) results, which amounts to 108 basis points, is somewhat less than the comparable ORA spread. However, it is clear that a fairly large spread in model results is common and not counter to our objective to determine a reasonable range. Once such a range is determined, we will exercise our judgment in determining the authorized return for SCWC.

Regarding the differences in the results, SCWC and ORA criticize each other's models. For instance, for the DCF, ORA criticizes SCWC's adjustment of the dividend yields to account for market pressure and issuance costs. ORA states that, in D.92-11-047, the Commission rejected the use of issuance costs and sinking fund effects in determination of rate of return. SCWC criticizes ORA's DCF formula on the grounds that ORA uses data from the most recent six and twelve- month periods, and not just the most recent three- month period, which SCWC characterizes as the only "current" data. ORA asserts that its approach takes advantage of a longer time period to average out any short-term aberrations, though in this case the results for the three, six and twelve months were all within one one-hundredth of a percent.

Regarding the RP analysis, SCWC criticizes ORA's model on the ground that it uses "too much history," which is wrong because "history does not repeat itself." ORA argues that using just the 5-year period, which SCWC proposes,

would ignore the longer-term trends in the model. ORA asserts that its RP model is superior to SCWC's proposal because it balances historical trends in the risk premium with forecast interest rates to arrive at return on equity.

Based on the record, we do not see either SCWC's or ORA's analyses as clearly superior, and we will consider the determinations of both ORA and SCWC. We adopt an equity return range of 9.08% to 10.70% for SCWC. We derive the floor rate by taking the simple average of the parties' DCF results and the ceiling by taking the simple average of the RP results.²⁶

In order to determine where SCWC should fall in that ROE range, we next assess the risk factors.

14.4. Return on Equity – Discussion of Risk

We see no indication of high financial, business or regulatory risk for SCWC. After considering that along with evidence on the financial models, adjustments to the models, interest rate trends, the current economy and our informed judgment, we have determined that the midpoint of our range (9.90%) reflects an appropriate equity return for SCWC. We therefore authorize this return for SCWC's Region III for the years 2003, 2004, and 2005. This return along with our adopted capital structure and costs of debt, equates to a rate of return on rate base of 8.79% for test year 2003, 8.77% for test year 2004 and 8.79% for attrition year 2005.

Risk factors consist of financial, business and regulatory risk. Financial risk is tied to the utility's capital structure. The proportion of its debt to

²⁶ For the DCF, SCWC shows a return of 9.81% while ORA shows 8.35% (including Artesian). The average is 9.08%. For the RP, SCWC shows a return of 10.89% while ORA shows 10.52% (including Artesian). The average is 10.70%.

permanent capital determines the level of financial risk that a utility faces. As a utility's debt ratio increases, a higher return on equity may be needed to compensate for that increased risk. Both SCWC and ORA utilize a capital structure consisting of 50% debt and 50% equity, and neither party asserts increased or decreased financial risks associated with that structure.

Business risks pertain to uncertainties resulting from competition and the economy. A utility that has the most variability in operating results has the most business risk. Regulatory risk pertains to new risks that investors face from future regulatory actions that we, and other regulatory agencies, might take. Assessments of these risks are conducted to determine whether there is a need to increase return to compensate investors for added risk.

In its application, SCWC identifies and quantifies two elements of risk. First, it asserts business risk associated with the capital intensive nature of water utilities and operating leverage concerns caused by California water utilities having higher than average quantities of purchased water (fixed costs). However, the Commission has provided various regulatory mechanisms that deal with this risk – balancing accounts for purchased water, purchased power and pump taxes; memorandum accounts for catastrophic events; memorandum accounts for SDWA compliance; 50% fixed cost recovery and construction work in progress in rate base. Also, in this decision, we have approved memorandum account treatment for the Calipatria treatment plant. All of these factors tend to reduce risk associated with the capital intensive and high fixed cost nature of SCWC's operations. We see no reason to add a premium to the ROE to compensate for these risks.

The second risk specifically identified by SCWC concerns potential adjustments to balancing account procedures raised in Resolution No. W-4294.

At the time of the application filing, related issues were being considered in R.01-12-009 where, on June 19, 2003, the Commission issued a final decision. In summary, D.03-06-072 revised the existing procedures for recovery of under collections and over collections in balancing-type memorandum accounts (accounts) existing on or after November 29, 2001 as follows: (1) If a utility is within its rate case cycle and is not over earning, the utility shall recover its account subject to reasonableness review; and (2) If a utility is either within or outside of its rate case cycle and is over earning, the utility's recovery of expenses from the accounts will be reduced by the amount of the over earning, again subject to reasonableness review. The utility shall remove the amount of the over earning from the account and shall amortize it below the line. Utilities shall use the recorded rate of return means test to evaluate earnings for all years.

Conclusion of Law 7, states in relevant part:

“[T]he readjustment of a utility’s specific rate of return is not within the scope of this industry-wide proceeding. The appropriate forum for such a utility-specific inquiry is a utility’s general rate case or other appropriate proceeding the Commission may designate in the future.”

The affect of D.03-06-072 is to limit recovery of costs subject to balancing accounts when the utility is over earning its authorized rate of return. The issue is whether this imposes additional risk on the utility to the extent that a premium should be added to the equity return. In the policy discussion of D.03-06-072, we state:

“Like the Edison case, we believe that a revision to our existing procedures is necessary here in order to effectively correct distorted results. The existing procedures for recovery of under and over collections in balancing accounts, which we suspended as of November 29, 2001, were originally established for the utilities to recover unanticipated increases in electricity costs between general rate cases, without the need to file an additional rate case application. The procedures also served the purpose of protecting shareholders from having to finance large unanticipated expenses until the next general rate case.

“These procedures served, in effect, as insurance to protect a utility against its failure to earn its authorized earnings due to unanticipated expenses beyond the utility’s control. When a person obtains insurance, the insurance is paid or invoked when the event insured against occurs. Similarly, offset balancing account recovery should only occur when the utility fails to earn up to its authorized rate of return due to unanticipated expenses beyond its control and that are the subject of the balancing account. To the extent a utility is earning above its authorized rate of return, recovery of the balancing account should be reduced by the amount of over earning since the event insured against (i.e., the failure to earn its authorized earnings) has not occurred.

“Thus, the existing procedures become problematic when they have the effect of enhancing utilities’ earnings above the Commission-authorized rates of return. It is unreasonable and unnecessary to permit the utilities to pass through to ratepayers the dollar-for-dollar costs accumulated in their balancing accounts when these same utilities are earning more than their authorized rate of return, particularly when their ratepayers are also experiencing the same increased electrical costs in their own homes. To permit such recovery would be to grant the utilities an unanticipated windfall at ratepayer expense.” (D.03-062-072, *mimeo.* at pp. 15-16.)

As described above, D.03-06-072 corrects an imbalance in the risks associated with previous balancing account procedures. The opportunity for unanticipated windfalls caused by balancing account protection should not have existed from the beginning. It would be illogical for us to increase the ROE by 90 basis points, as requested by SCWC, to compensate for the loss of what has been determined to be an illegitimate opportunity.

Additional information in the record indicates that SCWC is financially healthy. In evaluating SCWC’s risk, ORA considered the Standard & Poor’s (S&P) credit rating of SCWC, since this rating factors in a company’s total risk. S&P rates SCWC A+/Stable, Business Profile 3. ORA Table 3-1, contained in Exhibit 9, shows S&P benchmark financial ratios as compared to SCWC for the years 1997-2001. According to ORA, based on those ratios, SCWC’s overall rating would be “A,” a strong indication that it is a financially healthy company. Placing SCWC in the middle of our ROE range appears fair and puts the

authorized return in line with that recently authorized for other large water utilities under our jurisdiction.²⁷

15. Sales

SCWC and ORA do not agree on forecasts of the annual sales per commercial customer, as summarized in Paragraph 3.02 of the Stipulation. In estimating sales for the commercial class, SCWC used a monthly regression model, while ORA used the Modified Bean method, which incorporates annual data. As discussed below, we will adopt SCWC's estimates for commercial sales per customer.

15.1. Discussion

The monthly regression model used by SCWC produces results which are statistically more significant than that produced by ORA's model, which failed the F-statistic and Durbin – Watson tests. Additionally, the Water Division²⁸ and Commission decisions²⁹ have encouraged the use of a monthly regression model.

²⁷ For example, in D.03-05-078, Suburban Water Systems was authorized a 9.84% ROE for 2003 – 2005; in D.03-02-030 California-American Water Company was authorized a 10.25% ROE for 2003 – 2005; and in D.03-09-021 California Water Service Company, based on a joint recommendation, was authorized a 9.70% ROE for 2002-2005.

²⁸ See Exhibit 54, which quotes the Commission's Water Division document, "Water Regulatory Policy," prepared in August 1997, where it is noted that sales forecasting is an important part of GRC proceedings and that, "[i]n 1992, the Modified Bean method was replaced with an Econometric Model which expanded the statistical data information and calculations to include additional variables."

²⁹ See D.94-06-033, 55d CPUC 2d at 190, where the Commission noted that the Division of Ratepayer Advocates had introduced an econometric forecasting method in two water company rate cases and was "encouraging all Class A water companies to use this method instead of the more traditional modified Bean forecasts." Also, the Commission stated that "[b]ecause it produces more accurate estimates of future sales

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ORA does not address these points, which are significant in considering a return to the use of the Modified Bean Method. For these reasons, we adopt test year sales per customer for the commercial class, as forecasted by SCWC.

ORA's criticisms of the monthly regression model lack specific evidence and analysis. For instance, in criticizing SCWC's conservation factor, ORA states that the conservation factor used in the utility's model is an unreliable variable in that it is not measuring a phenomenon known to affect consumption. ORA does not provide evidence that shows the factor is unreliable, does not quantify the effect of using the factor, does not analyze the effects of modifying the value of the factor, does not indicate how ORA specifically addressed conservation, and does not provide an alternative method for addressing the effects of conservation. Such information would be helpful in evaluating the merits of ORA's position.

16. Water Supply Mix

For the Claremont CSA, SCWC projects that approximately 38% (2,130,623 Ccf) of its water supply for the test years would come from groundwater pumped from SCWC wells within the CSA. ORA, on the other hand, estimates an amount of 2,684,500 Ccf, or 48% for both years

SCWC argues that ORA's estimate is unrealistic for the following reasons. First, groundwater production has declined for the past 5 years and is expected to continue to decline. Second, the Master Water Level Index in the Six Basins, from which the Claremont wells draw, is falling, thereby reducing the amount of water that SCWC is capable of pumping from its wells. Third, SCWC's wells in

than the Bean method, the econometric model can reduce utilities' risk of underestimating (or overestimating) sales revenue."

the Claremont CSA also suffer from contamination concerns. Wells have been unreliable due to water quality issues (VOCs, bacteriological, and mechanical). In addition, in 2004, the new standard for arsenic becomes effective and the largest single producing well in the Claremont CSA will have to be shut down due to arsenic. Fourth, the two wells that are budgeted for the Claremont CSA (1 for 2003 and 1 for 2004) are intended to be replacement wells, not to provide an increase in production capacity. These new wells are needed because 16 out of 18 SCWC-owned wells in the Claremont CSA are more than 50 years old, with an average age for the 18 wells of 69 years.

ORA argues that its recommendations for Claremont are based on better, more realistic analysis than SCWC's and are consistent with its approach in other districts. ORA asserts that its forecast discards unusually high and low years to try to predict a more "average" year in the future based on past trends and considers the fact that two new, deep wells - which are more immune to spikes in rainfall - are scheduled to be built by the company in 2003 and 2004.

As discussed below, we adopt a groundwater pumped amount of 2,328,374 Ccf for both 2003 and 2004.

16.1. Discussion

The groundwater production in the Claremont CSA has declined substantially and is unlikely to return any time soon to levels achieved in the 1997 to 1999 timeframe. SCWC has provided information showing that new wells in 2003 and 2004 will replace and not supplement groundwater production. The recorded information for the years 2000–2002 indicates significantly less

pumped water than for the years 1997-1999,³⁰ and is significantly less than ORA's forecasted amounts. However, the data are not consistent with SCWC's assertion that the decline in groundwater production over the past five years will continue. Recorded year 2002 groundwater production of 2,328,374 Ccf is higher than the 2001 amount of 2,130,617 Ccf and very close to the 2000 amount of 2,389,100 Ccf. The SCWC witness indicated that 2002 recorded data were not available at the time estimates were prepared and that the expectation was that production would be similar to that recorded in 2001.³¹ We see no reason why the most recent recorded amount of 2,328,374 Ccf for 2002 cannot be obtained from groundwater wells in 2003 and 2004. We adopt 2,328,374 Ccf as the quantity of water from wells for both 2003 and 2004 and assume that purchases will constitute the remaining portion of water supply for each of those years.

17. Supply Cost Increases

SCWC forecasted its supply costs – cost of purchased power, cost of purchased water, and pump taxes – for the test years 2003 and 2004. SCWC used the most current rates for each of the purveyors to forecast its supply costs for 2003. SCWC and ORA have agreed that all purveyor rates utilized in calculating purchased water and purchased power costs should reflect current purveyor rates when the final decision appendices are compiled.

For the second test year, SCWC inflated the purchased water and purchased power costs to cover the anticipated increase in purveyors' rates.

³⁰ See Exhibit 61. The recorded amounts for 1997 through 2002 were 3,619,000 for 1997; 3,088,000 for 1998; 2,932,500 for 1999; 2,389,100 for 2000; 2,130,617 for 2001 and 2,328,374 for 2002.

³¹ SCWC, Wahab, Tr. 890.

SCWC states that inflating first test year costs to derive second test year costs is commonly done for many expense items in the general rate case. ORA, on the other hand, held the supply costs at the 2003 levels when projecting 2004 costs. We will follow ORA, as discussed below.

17.1. Discussion

We will not adopt SCWC's proposal for two reasons. First, the record does not include a detailed basis for the proposal. The company's testimony indicates only that the rates are inflated to cover anticipated increases. Without a detailed description, we cannot determine whether SCWC's estimating methodology is reasonable and balanced in considering possible decreases as well as increases. For instance, it is not clear whether, in estimating purchased power rates, the company considered the recent decrease in Southern California Edison's electric rates (D.03-07-029). The effect of that decrease can be incorporated in the decision for this GRC for 2003, as agreed to by both ORA and SCWC, but how the rate for 2004 should be adjusted is unclear.

Second, the issue of balancing account recovery for water utilities was the subject of R.01-12-009. In D.03-06-072, the Commission determined that increases related to balancing account recovery should be granted only to the extent that the utility's rate of return does not exceed authorized levels. Forecasting future water supply rate increases in this GRC would subvert the review process set forth in D.03-06-072. That process uses an earnings test to determine whether or not any such increase, or any portion of the increase, should be reflected in rates. SCWC can use the processes adopted in D.03-06-072 to mitigate the effects of 2004 increases, if any.

18. General Office Labor

GO labor includes labor associated with common customer account expenses and A&G expenses. SCWC estimates GO labor to be \$7,765,300 in 2003 and \$8,120,400 in 2004, while ORA estimates \$6,445,900 for 2003 and \$6,627,700 for 2004.

As discussed below, we adopt GO labor in the amounts of \$6,864,200 for 2003 and \$7,077,000 for 2004.

18.1. Discussion

A reasonable estimate of GO labor lies somewhere between the SCWC and ORA numbers. ORA used 2001 recorded expenses and escalated that amount by labor inflation factors to estimate the test year amounts. As SCWC points out, that methodology does not consider the effects of the CPP. On the other hand, even when considering the effects of the CPP, SCWC's estimates appear to be high when compared to recorded information.

The last recorded year not affected by the CPP was 2000. GO labor expense for that year was \$5,723,700.³² SCWC's test year 2003 request of \$7,765,300 exceeds the 2000 recorded expense by \$2,041,600, or 35.7%, which is a substantial three-year increase. SCWC's testimony offers little in the way of justification for the large increase other than identifying the need for an additional auditor and indicating that some of the unfilled vacancies were necessary to fulfill the requirements of the Sarbanes-Oxley Act of 2002 and other new Securities and Exchange Commission rules. When possible, recorded data is useful in testing the reasonableness of utility budgets. We note that the recorded

³² See Exhibit 27, Table 4-A.

2002 GO labor expense amounted to \$6,002,175,³³ which is 20% less than the \$7,519,900 estimated by SCWC for that year. The difference appears to be greater than the effect of the CPP. SCWC explains, “Although the CPP ended in mid-2002 and the hiring freeze was removed, many positions were not actually filled until the end of 2002, or the beginning of 2003, so again the 2002 recorded expense does not include some or all of the costs associated with these positions.”³⁴ SCWC further states that, at the time of the application (November 2002), there were 14 positions in the general office that were not filled. The expense portion of the related salaries amounted to \$740,700. This is consistent with SCWC’s explanation that during the CPP there was a company-wide hiring freeze and, at its peak, there was close to a 10% vacancy rate within the entire company (including proposed new positions). If the recorded 2002 expense were adjusted for the 14 vacancies, the amount would be \$6,742,875. We feel this would be a reasonable basis for determining the test year estimates for GO labor expense. The positions have either been filled or are necessary for auditing purposes. SCWC used labor inflation factors of 1.8% for 2003 and 3.1% for 2004. Application of those factors to the adjusted 2002 recorded expense results in our adopted estimates of \$6,864,200 for 2003 and \$7,077,000 for 2004.

SCWC included 1.5% per year increases for equity adjustments. The utility’s showing, however, does not provide the basis for the adjustment or describe how the percentage was determined. Therefore, we will not adopt the adjustment. SCWC also includes an explicit overtime factor based on year 2000

³³ See ORA Opening Brief, p. 19.

³⁴ Darney-Lane, Exhibit 45, pp. 1-2.

information, indicating that overtime during the CPP timeframe is not indicative of normal operations. In this case, it is not clear that 2000 overtime is reflective of what can be expected in the test years. SCWC had estimated 2003 GO labor expense that was 35.7% higher than the 2000 recorded amount. Our adopted amount for 2003 is 19.9% higher than the 2000 recorded amount. Some of the overtime incurred in 2000 should no longer be necessary due to the increased staffing included in the test year amounts. What that amount should be is unclear; however, our methodology in adopting the test year estimates includes recorded 2002 overtime. We assume that amount and the new positions will cover overtime needs. Lastly, we assume that the new auditor position specifically requested by SCWC is included in our estimates. The increased costs should be more than offset by the specific assignment to Region 3 of the water quality manager and support analyst, who were previously in, and charged to, the general office.

19. Security Plan

In response to the events of September 11, 2001 and ongoing security-related warnings issued by the federal government, SCWC has developed a Security Plan in conformance with industry guidelines and the recently enacted Public Health and Bioterrorism Response Act signed by President Bush into law on June 12, 2002. SCWC indicates that it recognizes the need for increased security and is currently spending capital and O&M funds to that end.

In its application, SCWC included \$15,250,193 for GO capital and \$809,300 for GO O&M costs for the security plan. Rebuttal testimony revised the amount by spreading the costs over six years. This plan does not alter the cost components of the plan; it only spreads the implementation of the plan over two rate case cycles rather than implementing the entire program in a single year.

SCWC's most recent position, as depicted in the Stipulation appendices, incorporates the six-year plan.

ORA opposes the \$15.5 million security plan proposed by SCWC. ORA does not oppose increased security per se, but large expenditure and heightened security is an issue that affects all utilities after September 11, and would best be left to a separate proceeding. ORA argues that SCWC has not met the burden of proof for justifying such a large expenditure. ORA recommends the Commission require a separate application on this security plan or open an OII on this issue for water utilities specifically.

As discussed below, we will incorporate the company's six-year plan in the revenue requirement for this GRC cycle.

19.1. Discussion

SCWC is ultimately responsible for the security of its system and we will not interfere with the company's plans to address these important concerns. Our adopted capital expenditures will therefore include security plan amounts to be spent in 2003 and 2004 consistent with the six-year plan proposed by SCWC in Exhibit 42, Exhibit A.

For this application, SCWC has characterized its request to specifically include cost recovery for the following general security measures:³⁵

1. The purchase and installation of equipment for detection of intruders.
2. The purchase and installation of fencing, gating, lighting, or security cameras.
3. The re-keying of doors and locks.

³⁵ SCWC, Gedney, Exhibit 29.

4. Improvements to electronic, computer, or other automated systems and remote security systems.

While these appear to be reasonable measures, the reasonableness of SCWC's proposed program scope and estimated costs is somewhat difficult to ascertain. The record does not include the identification and justification of specific elements or projects³⁶ related to the capital expenditure proposal that is estimated to be over \$15 million. Therefore, we recognize that the evidentiary record for these forecasted security related expenditures might not be as detailed as for other capital projects. However, due to the nature of capital cost recovery, we also realize that the majority of the recovery of the security plan capital costs will be based on actual recorded costs that will be used to determine rates in subsequent GRC proceedings. SCWC must be able to demonstrate the reasonableness of the completed elements of the security plan at any time in the future. As such, the company is at risk for cost recovery for completed elements of the plan on a prospective basis.

We are only authorizing security plan expenditures for Region III, which is the subject of this application, for the years 2003 and 2004 specifically and for the year 2005 by the attrition mechanism. We expect that as the political situation evolves over time, the perceptions of appropriate risk and costs may change. Such change should be incorporated prospectively, to the extent possible. Since, by this decision, GO costs determined in this proceeding will not be allocated to the other regions, those security plan costs will have to be recovered in GRCs for

³⁶ SCWC classified its security plan as confidential and as such details are not provided as part of its direct or rebuttal testimony. A copy of the plan was provided to ORA for its analysis.

those regions. We expect that the security plan will continue to be evaluated at those times as well as in future GRCs for Region III. That evaluation may include the review of actual expenditures and necessary changes to the plan. If the Commission opens an OII on the subject of water utility security as suggested by ORA, the results of that investigation can be applied prospectively, as appropriate, to SCWC's plan.

20. Customer Information System Software

SCWC included in its 2004 GO capital budget approximately \$5.4 million to replace its Customer Information System (CIS) software. SCWC states that the current system is becoming increasingly more costly to operate and less capable of meeting SCWC's needs.

ORA recommends denial of the \$5,412,500 CIS funding on the grounds that it had not been properly justified by SCWC. ORA stated that it was not opposed to the replacement of a legacy system with a modern cost effective system. However, the two-sentence justification given for such a large outlay was not sufficient to demonstrate the cost effectiveness of the new system and other efficiencies to be realized. In its rebuttal, SCWC provided additional information that attempted to describe the problem and the steps to put a new system in place, together with a breakdown of the expected costs to complete. However, SCWC did not provide a cost-benefit analysis that would show the savings in operating efficiencies.

As discussed below, we will not incorporate the company's proposed CIS project in the revenue requirement for this GRC cycle.

20.1. Discussion

We will not include this project in rates at this time because SCWC has not quantified savings associated with the project. By SCWC's own description of

the problems with the current CIS, there should be significant savings and efficiencies with a new system, thereby producing savings for the ratepayers, but it has not produced any information to confirm or quantify that proposition. Without that information, it is impossible to develop an opinion on the overall benefits of the project compared to costs and to incorporate appropriate savings in expense or capital forecasts.

This decision to exclude this project at this time does not prohibit SCWC from proceeding with the project at its own risk. If it proceeds on its own, neither the costs nor savings associated with a new CIS would be in rates. That situation would continue until SCWC requests inclusion of the project in a future GRC capital budget and that request is granted. In making any such request, SCWC should address all aspects of the project, including costs, allocation of costs to affiliates and savings.

This issue has also raised a concern regarding SCWC's burden in justifying its request. With the application, SCWC submitted testimony, which included a very brief description of the need for this particular project. After ORA recommended the project be rejected for lack of justification, SCWC provided a more detailed justification in rebuttal testimony. A project of this magnitude, which is in excess of \$5 million, requires more attention than what was given by the utility in initially justifying its proposed budgets. Providing the basic justification in rebuttal is unfair, since parties are not generally given the opportunity to respond to rebuttal with testimony of their own.³⁷ In this case,

³⁷ We note that D.89-01-040 (30 CPUC 2d 576) adopted the rate case plan for energy utilities and specifically defines the scope of rebuttal. It states, "Rebuttal evidence shall refute the evidence of other parties and shall not reassert or reargue a party's direct evidence. No bulk or major updating amendments or recorded data shall be allowed in

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rebuttal was issued on May 1, 2003 and hearings began on May 12, 2003. The timeframe to conduct discovery on rebuttal, even for the purpose of cross-examination, was limited. When the utility has the evidentiary burden, we caution against the use of rebuttal testimony to provide the basic justification. As a matter of fairness, we must seriously consider either striking such testimony or extending the proceeding, at the utility's risk, to allow for responsive testimony from the other parties.

21. Pensions and Benefits

A major part of the Pensions and Benefits (P&B) cost is for medical insurance premiums. SCWC indicates that in 2001, it spent \$5,417,307 on P&B expenses, while the recorded expense for 2002 was \$7,101,845, a 31% increase. SCWC states it expects to see a 13% increase in medical premiums for 2003/2004. Accordingly, the utility has projected its P&B expense to be \$8,085,700 in 2003 and \$8,711,800 in 2004.

ORA states that it estimated P&B costs by using 2001 expenses and escalating to 2003 and 2004 using ORA's escalation rates, while SCWC used an annual increase of 28% for health care costs based on some preliminary information it received from a health care provider and approximately a 10% increase for other cost components to derive its estimates. ORA argues that SCWC's proposed increases are excessive, that health care providers often quote higher rates at the beginning of negotiation, and that the projection of these costs is unreasonable. ORA notes that P&B cost has been fluctuating substantially and, in some years, it has actually declined substantially. For instance in 2000, the

rebuttal evidence." There is no such statement in the current water rate case plan, since it does not specifically provide for rebuttal testimony.

P&B expense declined 28%. ORA concludes that general inflationary increases are reasonable for the test year estimates.

SCWC argues that ORA's proposal to increase 2001 recorded expenses by less than 3% annually is inadequate to cover the costs that SCWC has already incurred and will incur in the future.

As discussed below, we adopt P&B expense amounts of \$7,598,900 for 2003 and \$8,130,900 for 2004.

21.1. Discussion

SCWC has provided information that shows its recorded P&B expense for 2002 was \$7,101,845. ORA's 2003 estimate, which was based on 2001 recorded information, amounted to \$5,261,500. This indicates that significant cost increases, especially in the medical area, are not covered by general inflation. For this reason, it appears reasonable to use the most recent recorded data as the basis for the test year estimates. The 2002 recorded P&B amount of \$7,101,845 will therefore be escalated to derive estimates for test years 2003 and 2004. We will consider SCWC's indicated 13% annual increase for medical in determining the appropriate escalation factors. There is also merit in ORA's argument regarding the use of a general inflationary increase due to factors such as fluctuations in historic costs, including significant reductions from one year to the next. Medical costs approximate 40% of the P&B expense. We will weight the 13% projected annual medical increase by that 40% and the annual general inflationary increase of 3% by the remaining 60% of P&B expense. The resultant escalation factor is approximately 7% per year. The 7% annual escalation is applied to the recorded 2002 P&B expense to derive the adopted amounts of \$7,598,900 for test year 2003 and \$8,130,900 for test year 2004.

22. Reconnection Fees

SCWC Tariff Rule No. 11, paragraph C, subsection 1, addresses the reconnection fee charged when services have been discontinued for violation of SCWC's rules or for nonpayment of the bill. The existing fee is \$10 for reconnection during regular working hours or \$15 for reconnection when the customer requests that the reconnection be made at other than regular working hours.

SCWC believes that the current fees do not reflect the true cost of the reconnection, and requests that the fees be raised to \$25 for reconnection during regular working hours and \$65 for reconnection outside of regular working hours. SCWC indicates that this increase would bring SCWC's reconnection fees in line with the fees California Water Service (CWS) charges its customers for the same service.

In its opening brief, ORA states its opposition to the reconnection fee increase for work done during non-working hours, indicating that the true cost of connection has not been documented. ORA also states that it is not in a position to assess why CWS charges this rate and whether or not it is reasonable.

In response, SCWC states ORA did not submit any testimony opposing SCWC's request to increase its reconnection fee and has no basis to contend that SCWC should not be reimbursed for its actual costs of reconnection.

ORA does not oppose the fee increase from \$10 to \$25 during working hours, and the increase appears reasonable. We will adopt that increase. Costs for work during non-working hours should be higher, principally for premium pay considerations. While ORA did not submit any testimony on this issue, SCWC still has the burden to demonstrate why its charges are reasonable. In that respect, there is little evidence on the record, other than SCWC's claim that

the new charge reflects true costs and is in line with that charged by CWS. The current non-working hour fee is 150% of the current working hour fee, which seems reasonable if overtime pay is necessary. The proposed non-working hour charge is 260% of the proposed working hour charge. The disproportionate increase is questionable and unexplained. We will therefore maintain the current 150% differential in determining the non-working hour charge. Increasing the proposed \$25 working hour charge by 150% results in a fee of \$37.50. In the absence of true cost documentation, we will adopt \$37.50 as the non-working hour reconnection fee.

23. Comments on Proposed Decision

The proposed decision (PD) was mailed to the parties in accordance with § 311(d) and Rule 77.1. Comments were filed by SCWC, ORA and the City of Claremont on December 12, 2003, and reply comments were filed by SCWC and ORA on December 17, 2003. A revised PD was also distributed, with concurrent comments due on February 20, 2004. No comments on the revised PD were received.

23.1. SCWC Comments

SCWC addressed the PD's rejection of portions of the Settlement, rejection of the company's proposal to allocate general office costs to non-GRC districts in this proceeding, treatment of costs imposed by affiliates, reduction to O&M expenses due to the CPP, allocation of revenues from the Folsom lease, recommended return on equity, determination of the supply mix in the Claremont CSA, and adopted level of pensions and benefits expense.

Regarding the rejection of the Settlement's proposed advice letter process for capital recovery, SCWC states that its intent was that there would only be 10 or so advice letter filings associated with the 51 projects. However, whether there would be up to 51 advice letter filings, resulting in a burden on the Commission staff and customer confusion, was only one problem associated with

the Settlement proposal. The more general and overriding concern is whether the advice letter procedures are appropriate when considered in the context of test year ratemaking. As the PD states, the proposed advice letter proposal results in after-the-fact cost recovery for capital projects on a recorded cost basis, which conflicts with the idea of test year ratemaking where reasoned estimates are the basis for rate recovery and where, at least for the rate case period, certain shareholder/ratepayer risks are associated with potential over-spending or under-spending of adopted test year amounts. From this standpoint it is not appropriate to include normal projects that should be handled on an estimated test year basis, through advice letter filings. We see no reason to change the PD's rejection of this process.

The PD also rejected the advice letter process for the Calipatria treatment plant, since the ultimate cost of this large project is unknown. The PD preferred to handle the project through a separate application or in the next GRC, where the reasonableness of the costs can be examined. The PD authorized SCWC to establish a memorandum account with carrying costs equal to the rate of return without gross up for taxes. We do not accept SCWC's comments that the carrying costs should be equal to the pre tax rate of return (grossed up for taxes). When construction work in progress is recovered in rate base on an estimated basis, it would be recovered at the pre tax rate of return. This is appropriate since there is associated revenue, on part of which taxes must be paid. However, accumulating the carrying costs in the memorandum account is similar to an allowance for funds used during construction (AFUDC). AFUDC is not grossed up for taxes, since there is no associated revenue at the time it is incurred. The costs are recovered through depreciation expense and the rate of return on rate base, once the plant is in service. The allowance for taxes on equity funding is made at that time. Similarly, when rates are established for the Calipatria plant,

the disposition of the accumulated carrying costs will be determined. This should include the effect of taxes associated with equity funding.

SCWC also objects to the PD's use of alternative estimates for water supply and conservation projects. SCWC states that the PD discounts SCWC's evidence of the costs of each project simply because SCWC did not submit rebuttal testimony in response to ORA's evidence on each project. SCWC claims it did not submit rebuttal because it had reached a stipulated outcome with ORA before rebuttal was due, and it urges that its estimates should be used for these projects. We disagree. The utility must justify its proposed capital budgets. This should be done in its direct testimony. Additional support can be contained in workpapers, but there should be sufficient information on the record for the Commission to determine need, reasonableness of costs and timing. While the record justifies very little of SCWC's proposed capital budget, we have, for this case, assumed ORA's review of the other projects to which it did not object is sufficient. There are however concerns regarding ORA's adjustments in its direct testimony. Whether or not rebuttal testimony is filed is the company's decision. SCWC did not file rebuttal and, in light of ORA's direct testimony, the record does not support the company's estimates. There is no basis to change the PD on this issue.

Regarding reservoirs, SCWC also questions the PD's timing for two Barstow reservoirs, claiming one should be authorized for 2004 and one for 2005. The PD assumed that those projects would go into service, on average, at the beginning of 2005 (or the end of 2004), the midpoint of the remaining two years in this GRC cycle. This is the same as putting one well into service in mid-2004 and one in mid-2005, which should satisfy SCWC's stated needs.

Regarding the company's proposal to allocate GO costs to non-GRC districts, the PD stated we could not determine the accuracy of the incremental proposal. There is a concern regarding the embedded attrition year amounts for

expense and capital in the non-GRC districts. SCWC's direct testimony did not describe how the embedded GO amounts for expense and capital for the non-GRC districts would be determined. Information contained in workpapers, if any, was not made part of the record. In rebuttal testimony, SCWC stated that GO costs are incorporated into their rates reflecting the previously adopted GO costs (from the most recent GRC) adjusted for inflation. However in cross-examination, the witness indicated that the statement might be too general considering the nature of capital budgets as well as specific test year expense adjustments. Whether the embedded attrition year GO expense and capital related costs for the non-GRC districts have been, or can be, appropriately determined has not been demonstrated and we will not change the PD on this issue. We do not preclude future rate case decisions from allocating GO costs to all districts. We only require that any proposed procedure be fully described and documented on the record so that the reasonableness can be determined.

Regarding reimbursement by ASUS for costs incurred by SCWC for services it provides to ASUS, SCWC provides information that shows certain direct labor and overhead charges are already shared by ASUS.³⁸ However, SCWC states that with respect to other costs, ASUS reimburses SCWC by sharing a percentage of the revenues it receives from the contract with SCWC. SCWC further states that, in that way, revenue sharing acts as a proxy calculation for the costs SCWC incurs in providing services to SCWC. It is these other costs that should be directly charged or allocated to ASUS, since the PD concludes that the sharing mechanism is not the appropriate means for ASUS to reimburse SCWC. The cost study ordered by this decision should therefore address the charges or

³⁸ In its comments SCWC requests the Commission take notice of its annual reports of affiliated entities and attached the 2002 report. Since these reports are provided to the Commission pursuant to a stipulation adopted by D.98-06-068, we will take notice of the 2002 report, which was the only one provided.

allocations to ASUS for these other costs. The PD's imputed revenue of \$101,300 is not a duplicative adjustment. It is a proxy for the amount that should be charged or allocated to ASUS in lieu of the reimbursement by ASUS through the sharing mechanism and amounts to \$37,900 more than the estimated \$63,400 of sharing revenues proposed by SCWC.

Regarding the PD's CPP adjustment, SCWC's comments maintain that projects deferred in 2001/2002 have been completed in 2003 and no adjustment should be made. SCWC offers to make 2003 recorded information available. However, the record in this proceeding is closed, and an analysis of 2003 recorded information for consideration in this decision is not appropriate without reopening the proceeding. An analysis would have to be done to determine what the deferred costs are and whether any are built into the 2003/2004 estimates for this rate case. The PD addressed the problem of potential recovery of deferred maintenance in future rate case cycles. The problem of potential windfalls due to balancing account treatment for the BVE costs still remains. In its comments, SCWC suggests that if the PD's proposed adjustment is adopted, the BVE customers should reimburse SCWC for the funds. However, the PD's point is that it was the shareholders, not the electric customers, who benefited from the water utility (as well as certain electric utility) deferrals. No change to the PD's CPP adjustment is warranted.

Regarding the Folsom Lease issue, SCWC reargues its points regarding the PD's classification of the lease as utility property. We see no error³⁹ in the PD's conclusion that water rights are an essential element of operating a water utility; those rights can be "enjoyed" even if they are not immediately exercised, the

³⁹ Rule 77.3 states that comments shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record. Comments which merely reargue positions taken in briefs will be accorded no weight and are not to be filed.

original water rights were therefore utility property and the remaining water rights continue to be utility property under the jurisdiction of this Commission.

SCWC also disagrees with PD's allocation of the benefits of the lease, arguing that the entire amount should accrue to shareholders. Given our determination that the water rights are utility property, SCWC's arguments⁴⁰ do not provide evidence of factual, legal or technical error in the PD's findings and conclusions that it is reasonable to allocate the benefits of the lease between shareholders and ratepayers.

Regarding return on equity, we find no reason to change the conclusions reached in the PD. SCWC's comments reargue its position on risk associated with the balancing account rulemaking. Based on the principles contained in D.03-06-072, those arguments were considered and rejected by the PD. There is no need to address them again. New information attached to SCWC's comments is untested by cross-examination, inconclusive and will not be considered in this decision. Regarding regulatory risk, SCWC is correct in pointing out that the PD's reference to the acceptance of the advice letter process for the 51 capital projects is wrong and should not be reflected in the related discussion. That reference will be corrected.

Regarding the supply mix in the Claremont CSA, we see no reason to lower the amount of pumped water supply below what was achieved in 2002. SCWC's comments point out that the PD acknowledges that the two new wells,

⁴⁰ Rule 77.3 also states that new factual evidence, untested by cross-examination, shall not allowed be included in comments and shall not be relied on as the basis for assertions made in post publication comments. As part of its comments SCWC attached new information on a mediated settlement regarding the Cordova system groundwater contamination litigation that SCWC instituted against Aerojet and the State. The settlement is not evidence in this proceeding, the relevance to the Folsom lease has not been explained or tested by cross-examination, and it will not be considered in this decision.

planned in 2003 and 2004 would replace and not provide additional water supply, but defers the two new wells into 2005. SCWC states that to correct this discrepancy, either the wells should be put into service in 2003 and 2004 as requested or SCWC's lower pumping amount should be adopted. We do not consider this to be a discrepancy. The importance of the assumption that the two new wells would be used to replace rather than supplement the pumped water supply was that it justified not increasing the amount of pumped water beyond that already achieved by SCWC in 2002. For the well and reservoir projects that would be recovered directly in rates by this decision rather than through the advice letter process, the PD assumed that those projects would go into service, on average, at the beginning of 2005 (or the end of 2004), the midpoint of the remaining two years in this GRC cycle. Exactly when the Claremont CSA wells go into service is entirely at the discretion of SCWC, and we assume that will occur when the wells are needed.

Regarding P&B expenses, SCWC states that the PD excludes \$269,133 for 2003 and \$303,388 for 2004 to provide for medical and dental expenses for 14 now-filled GO positions. However, in determining the composite 7% annual P&B escalation rate over 2003 recorded amounts, the PD incorporated the approximate 13% per year increase beyond the recorded 2002 amounts for medical and dental that was advocated by SCWC and used in determining its updated medical and dental estimates. In essence, the PD adopted SCWC's medical and dental expense request, and it is assumed that any employee growth estimated by the SCWC is included in those amounts.

SCWC indicated that certain corrections should be made to the appendices of the PD. Those items were reviewed and appropriate changes have been incorporated in this decision.

23.2. ORA Comments

ORA requests that the PD be modified to clarify that SCWC should offset the water quality memorandum accounts with any payment by the polluters for the water contamination. The purpose of these accounts is to accumulate the net costs of meeting potential new water quality requirements for five specific contaminants. To the extent that there are reimbursements by other entities directly related to the projects and costs being accumulated in the memorandum accounts, it is reasonable to include those reimbursements as offsets to the compliance costs. The ordering paragraph will be modified to reflect this.

Regarding the Folsom lease issue, ORA disagrees with the PD's findings and conclusions regarding the prudence of the lease. The prudence standard used in the PD is that the determination of prudence or imprudence should be based on what was known or should have been known at the time the decision to act was made. It is a fact that certain growth materialized and certain wells were shut down subsequent to the signing of the lease. However, the record in this proceeding does not provide convincing evidence, especially in light of SCWC's rebuttal testimony, that these facts should have been known at the time the lease was signed. We therefore cannot conclude that SCWC's act of entering into the lease was imprudent.

ORA also disagrees with the PD's conclusions that § 851 approval was not required for the Folsom lease and shareholders should retain an allocation of the benefits of the lease. In both instances, the PD based its findings and conclusions on its interpretation of Commission precedents and the circumstances in this case. ORA comments provide alternative interpretations and arguments but do not provide evidence of factual, legal or technical error in the PD's findings and conclusions that indicate Commission authorization of the lease under § 851 was not required and that it is reasonable to allocate the benefits of the lease between shareholders and ratepayers.

ORA pointed out a technical error that has been incorporated in this decision.

23.3. City of Claremont Comments

The City of Claremont addressed the issue of regional rates by recommending that the PD be put aside until the validity of regional rates is resolved. This recommendation will not be adopted, since the PD resolved the validity in concluding that regional rates should be continued.

24. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and David Fukutome is the assigned ALJ in this proceeding.

25. Timing

Because this filing request rates for test year 2003, this decision should be made effective immediately.

Findings of Fact

1. The Stipulation includes 51 individual capital projects that are subject to advice letter filings and rate adjustment.
2. The filing of as many as 51 advice letters would be an administrative burden on the Commission staff.
3. The implementation of as many as 51 individual rate changes would cause ratepayer confusion and concern.
4. The need for the San Gabriel well has not been substantiated, and it will not be included in plant estimates for this GRC.
5. The appropriate estimated cost of the Lucerne Valley well, the San Dimas well, two Orange County wells, two Claremont wells and two Barstow wells is \$3,517,230, or 63.7% of the costs estimated by SCWC. On average, the estimated operational date for the wells is January 1, 2005.
6. The need for the Orange County reservoir has not been substantiated, and it will not be included in plant estimates for this GRC.

7. The appropriate estimated cost of the two Barstow reservoirs is \$1,130,000. On average, the estimated operational date for the reservoirs is January 1, 2005.

8. The reasonableness of the conservation capital budget has not been demonstrated, and those projects will not be included in plant estimates for this GRC.

9. Our resolution of the CPP issue results in a maintenance expense estimate that differs from the Stipulation amounts.

10. Affordability is a primary consideration in this proceeding as it was in A.98-09-040 where SCWC requested single tariff pricing for its Region III.

11. Regional rates effectively addresses the problem of affordability for high rate districts in SCWC's Region III.

12. The record in this case does not detail how incremental GO allocations for non-GRC districts would be determined.

13. Incremental GO allocations are not necessary under ORA's GO allocation proposal where the allocation is determined for each rate case.

14. SCWC and ASUS are subsidiaries of American States Water Company.

15. Through the CPP, SCWC customers paid, in part, for BVE purchased energy costs.

16. Through the balancing account procedure for costs incurred in 2001 and 2002, BVE will eventually be made whole for the appropriate and reasonable amount of purchased power costs.

17. On a company-wide basis, for the period in which the CPP was in effect, SCWC's actual O&M spending was \$3.6 million below authorized levels.

18. On a company-wide basis, SCWC's actual capital expenditures were \$39 million for 2001 and \$45 million for 2002; the amounts previously authorized by the Commission were \$37 million for 2001 and \$42 million for 2002.

19. The Region III recorded maintenance expense is \$2,807,800 for 2001 and \$3,307,00 for 2002.

20. When compared to amounts previously authorized by the Commission, the level of SCWC's capital spending was largely unaffected by the CPP. Therefore, for purposes of determining the effect of the CPP on SCWC's operations, it is reasonable to assume the majority of the effect relates to O&M expenses.

21. Based on the stipulated 2003 maintenance expense for Region III, reasonable estimates of maintenance expense that should have occurred in 2001 and 2002 are \$3,556,100 and \$3,616,200 respectively.

22. On an industry-wide basis, the adopted sales per customer are currently used for calculating revenues for the earnings test.

23. ORA's proposal to use weather-adjusted sales for the earnings test that is used to justify step and attrition increases is a change in an industry-wide policy that would affect all large water utilities.

24. Costs related to water quality requirements are difficult to forecast, until the appropriate authority or agency specifies the requirements.

25. SCWC presented its water quality record from March 1998 to December 2002, updating the data previously presented in I.98-03-013. No party disputed that information.

26. There is insufficient information on the record for the Commission to make a finding that SCWC remained in compliance with applicable drinking water standards and water quality regulations during the period March 1998 to December 2002.

27. Although assigned no particular plant value, 32,000 AFY in water rights were included in the purchase of the Natomas Water Company by SCWC in 1964.

28. SCWC's Folsom water system and 22,000 AFY of water rights were transferred to the City of Folsom in 1967.

29. Of the 10,000 AFY of water rights remaining after the transfer of the Folsom water system, SCWC had used no more than 3,451 AF in any year prior to the agreement to lease 5,000 AFY to the City of Folsom.

30. It was not until 2002 that SCWC had a need for more than 5,000 AFY for of the Arden-Cordova CSA.

31. SCWC has a future need for American River water rights that exceeds 10,000 AFY.

32. An update of DRI forecasts shows new issue coupon rates of 6.63% for 2003 and 8.47% for 2005.

33. For new debt, ORA calculates effective interest rates of 6.76% for 2003 and 8.62% for 2005.

34. Based on more recent information, it is reasonable to adopt the ORA forecast of the average cost of debt of 7.67% in 2003, 7.63% in 2004 and 7.68% in 2005.

35. Past rate of return authorizations for SCWC and authorizations for other Class A water utilities under Commission jurisdiction do not reflect the market to book adjustment proposed by SCWC.

36. SCWC's CAPM analysis includes data related to companies other than regulated water companies.

37. SCWC's Fama-French Three Factor Model, which has never been adopted for use by this Commission, is similar to the CAPM.

38. Since we have previously determined that water companies should not be compared to companies in other industries, we will not incorporate the results of the CAPM or the Fama-French Three Factor Model, as calculated by SCWC.

39. The inclusion of Artesian Resources in ORA's group of comparable companies results in ORA's DCF analysis yielding a return of 8.35% and the RP analysis yielding a return of 10.52%.

40. Based on the DCF and RP model analyses performed by SCWC and ORA (with the inclusion of Artesian Resources in ORA's comparable group), a reasonable ROE range is 9.08% to 10.70%.

41. After considering evidence regarding SCWC's financial, business and regulatory risk, it is reasonable to authorize an equity return that is in the middle of the range. The resulting return of 9.90% and our adopted debt costs equate to a rate of return on rate base of 8.79% for test year 2003, 8.77% for 2004 and 8.79% for attrition year 2005.

42. Regulatory mechanisms such as balancing accounts for purchased water, purchased power and pump taxes; memorandum accounts for catastrophic events; memorandum accounts for SDWA compliance; 50% fixed cost recovery; construction work in progress in rate base and advice letter recovery of certain capital projects are in place and mitigate business risk associated with the capital intensive nature of water utilities and operating leverage concerns where a utility relies on higher than average quantities of purchased water.

43. D.03-06-072, which was issued subsequent to SCWC's application filing, addresses issues related to revised procedures for recovery of under collections and over collections in balancing accounts.

44. D.03-06-072 corrects an imbalance in the risks associated with previous balancing account procedures. Specifically, it eliminates the opportunity for unanticipated windfalls caused by balancing account protection.

45. For the purpose of forecasting commercial sales, past Commission policy statements have encouraged the use of a monthly regression model as opposed to the Modified Bean method.

46. SCWC's monthly regression method for forecasting commercial sales yields statistically significant results.

47. ORA's Modified Bean method for forecasting commercial sales failed the F-statistic and the Durbin-Watson tests of statistical significance.

48. For the Claremont CSA, the recorded information for the years 2000–2002, indicates significantly less pumped water than for the years 1997-1999.

49. For the Claremont CSA, the recorded 2002 groundwater production of 2,328,374 Ccf is higher than the 2001 recorded amount of 2,130,617 Ccf and very close to the 2000 recorded amount of 2,389,100 Ccf.

50. Since the groundwater production in the Claremont CSA has leveled off over the last three recorded years, it is reasonable to use the 2002 recorded amount of 2,328,374 Ccf as the estimated pumped water quantity for this CSA, for both test year 2003 and 2004.

51. SCWC's forecasted supply cost increase for 2004 is unsubstantiated and conflicts with D.03-06-072.

52. A review process for increasing supply costs is set forth in D.03-06-072.

53. For general office labor, the recorded expense for 2002 is \$6,002,175.

54. The expense for general office labor, related to 14 vacant positions in 2002, is \$740,700.

55. A reasonable test year estimate for general office labor is the recorded 2002 amount increased by the expense related to 14 positions that were vacant in 2002, escalated to 2003 and 2004 by the adopted labor escalation factors.

56. General office overtime levels for 2000 are accounted for in the 2003 and 2004 estimates, specifically by the inclusion of 14 additional positions and implicitly through the use of the 2002 recorded amount, which includes some amount of overtime, as the base for the test year estimates.

57. SCWC proposes a six-year phase-in of its security plan.

58. SCE has not produced any information to confirm or quantify its assertion that the proposed CIS will be less labor intensive and more efficient, thereby producing savings for the ratepayers.

59. The recorded P&B expense for 2002 is \$7,101,845.

60. For the test year estimates of P&B expense, the recorded 2002 amount of \$7,101,845 should be escalated to 2003 and 2004 amounts. For P&B escalation, an annual medical escalation factor of 13% should be weighted by 40% and an annual general escalation factor of 3% should be weighted by 60%, resulting in annual escalation of 7%. The resultant test year estimates for P&B expense are \$7,598,900 for 2003 and \$8,130,900 for 2004.

61. The true cost of reconnection during non-working hours has not been substantiated by SCWC.

62. It is reasonable to maintain a 150% differential between the working hour reconnection fee and the non-working hour reconnection fee. The resulting fee for reconnection during non-working hours is \$37.50.

Conclusions of Law

1. It is reasonable to allow SCWC to accrue capital costs related to the Calipatria treatment plant project in a memorandum account. SCWC can recover the costs of the project in a separate application or as part of the next GRC for Region III.

2. Other than the Calipatria treatment plant project, capital projects associated with proposed advice letter procedure contained in the Stipulation should be considered for rate recovery on an estimated GRC basis.

3. With the exception of the advice letter procedure for capital projects and the maintenance expense forecast, the Stipulation is reasonable and in the public interest and should be adopted.

4. Since affordability continues to be a problem and regional rates effectively address that problem, regional rates should not be altered at this time.

5. Since there may be viable alternatives to regional rates, parties should have the opportunity to address the subject in SCWC's next Region III GRC.

6. SCWC should continue to provide annual reports on regional rates as ordered and described in D.00-06-075. Reports should be served on all appearances in this proceeding.

7. Since concerns regarding the implementation of SCWC's incremental cost proposal for allocation of GO costs to non-GRC districts are not addressed in the record of this proceeding, the company's request to allocate GO costs determined in this GRC to non-GRC districts should be denied.

8. ORA's proposal to determine GO allocations in each GRC should be adopted, since this methodology has been used in the past and does not require the same incremental determination of step and attrition year rates as does SCWC's proposal.

9. D.98-06-068 specifies policies and guidelines for transactions between SCWC, the holding company and affiliates.

10. The affiliate transaction policies and guidelines specified in D.98-06-068 should be applied to SCWC's dealings with ASUS.

11. For contemplated dealings with ASUS in this GRC, SCWC has not applied the affiliate transaction policies and guidelines specified in D.98-06-068.

12. In lieu of an affiliate cost study for this GRC, it is reasonable to assign \$101,300 as affiliate related costs to be deducted from the GO revenue requirement.

13. For the future, SCWC should prepare a cost study and analysis, in order to fairly assign and allocate costs related to its affiliates, in accordance with the policies and guidelines specified in D.98-06-068.

14. SCWC customers should be reimbursed, in some manner, for the cash that was diverted from the water operations, due to the CPP. To do otherwise would result in a windfall for shareholders.

15. For this GRC cycle, shareholders should be responsible for \$352,200 of the annual Region III maintenance expense contained in the Stipulation.

16. ORA's proposal to use weather adjusted recorded sales per customer, for calculation of revenues in the earnings test, is a change in an existing industry-wide policy. It would be more appropriate and fair to consider the intent of the earnings test in a proceeding with all affected parties having the opportunity to participate.

17. Due to the manner in which this decision treats the Stipulation's proposed advice letter procedure for capital projects, SCWC's proposal to include the proposed 2003 and 2004 advice letter projects in the determination of the 2005 attrition year increase should be denied.

18. SCWC's request for memorandum account treatment for the costs to comply with MTBE, perchlorate, NDMA, radon and arsenic contamination is reasonable.

19. SCWC's request to amortize the Water Quality OII memorandum account accumulation, over a 12-month period, as a special condition surcharge applied to the quantity rate throughout the company, is unopposed and reasonable.

20. SCWC did not act imprudently when it signed the lease of water rights with the City of Folsom in 1994.

21. Since water rights were included in the transaction wherein SCWC acquired the assets of the Natomas Water Company, water rights are an essential element of operating a water company, and the Commission has previously determined that property rights can be "enjoyed" even if they are not immediately exercised, the entire amount of water rights acquired in 1994 was utility property. Since 22,000 AF of the original 32,000 AF entitlement has been transferred to the city of Folsom, SCWC's remaining 10,000 AF of water rights should be considered utility property under the jurisdiction of this Commission.

22. Based on the record in this proceeding, it is reasonable to assume that the water rights in question are separable for the purpose of sale or lease.

23. Based on Commission precedent, since 5,000 AFY were not immediately necessary or useful in the performance of SCWC's duties to the public, the utility was not required to seek Commission authorization under the provisions of § 851 in order to lease that 5,000 AFY to the City of Folsom.

24. Based on past actions of this Commission, it is reasonable to allocate the benefits of the lease between shareholders and ratepayers.

25. In this case, the actual impact of the lease on ratepayers is a reasonable basis to allocate the benefit of the Folsom lease between shareholders and ratepayers. Since the water leased to the City of Folsom was not required for the operation of the Arden – Cordova CSA until 2002, it is reasonable for the historic benefits of the lease, from 1995 through 2002, to accrue to the shareholders. Since replacement of those water rights will be required for the operation of the Arden – Cordova CSA from this point forward, it is reasonable for the prospective benefits of the lease, from the year 2003 forward, to accrue to the ratepayers.

26. Based on the record in this proceeding, the market to book adjustment proposed by SCWC is not necessary at this time.

27. An equity return premium based on the reasons advocated by SCWC would not be reasonable.

28. Since the monthly regression method used by SCWC, to forecast commercial sales, produces results that are statistically more significant than that produced by ORA's Modified Bean method and is consistent with the stated policy of the Water Division and Commission decisions, we should adopt SCWC's estimates for commercial sales per customer.

29. Rather than forecasting supply cost increases, such increases should be authorized through the review process adopted in D.03-06-072.

30. SCWC's request for a 1.5% equity adjustment for general office labor is unsubstantiated and should not be adopted.

31. SCWC's proposal to phase in its security plan over six years is reasonable and should be adopted.

32. The security plan should be reevaluated in subsequent GRC filings. Appropriate changes to the plan should be made and reflected in rates on a prospective basis.

33. In order to include the CIS project in rates, justification for the project should address need, costs, allocation of costs to affiliates and savings.

34. Since SCWC has not provided estimated savings related to the CIS project, the reasonableness of the project and the net costs to be included in rates cannot be determined. The costs and the savings related to the CIS project should therefore be excluded from rates determined in this decision.

35. SCWC's proposed fee of \$25 for reconnection during working hours is not opposed and should be adopted.

36. Today's order should be made effective immediately.

O R D E R**IT IS ORDERED** that:

1. Southern California Water Company (SCWC) is authorized to file in accordance with General Order 96-A, and to make effective on not less than five days' notice, the revised tariff schedules for 2003 included as Appendices B and G to this order. The revised tariff schedules shall apply to service rendered on and after their effective date.

2. Advice letters for authorized rate increases for 2004 and 2005 shall be filed in accordance with General Order 96-A, no earlier than November 1 of the preceding year. The filing shall include appropriate work papers. The increase shall be the amount authorized herein, or a proportionate lesser increase if SCWC's rate of return on rate base, adjusted to reflect rates then in effect, normal ratemaking adjustments, and the adopted change to the pro forma test, for the 12 months ending September 30 of the preceding year, exceeds the lower of (a) the rate of return on rate base found reasonable by the Commission for SCWC for the preceding year in the then most recent rate decision, or (b) the return on rate base authorized herein for the preceding year. The advice letters shall be reviewed by the Water Division for conformity with this decision, and shall go into effect upon Water Division's determination of compliance, not earlier than January 1 of the year for which the increase is authorized, or 30 days after filing, whichever is later. The tariffs shall be applicable to service rendered on or after the effective date. The Water Division shall inform the Commission if it finds the proposed increase does not comply with this decision or other Commission requirements.

3. SCWC is authorized to establish a memorandum account to accrue the costs of the Calipatria treatment plant project, with carrying costs computed using the authorized rate of return, without gross-up for taxes. SCWC may seek

cost recovery through a separate application or as part of the next Region III GRC.

4. SCWC is authorized to file an advice letter to modify the preliminary statement in its tariffs to describe and to, after the 30 day statutory timeframe, establish a memorandum account to accumulate the costs to comply with MTBE, perchlorate, NDMA, radon and arsenic contamination remediation requirements. Cost recovery shall be net of any previous expenses that were authorized to comply with previous remediation requirements that have been superseded, as well as any reimbursements directly related to the projects and costs being accumulated in the memorandum accounts.

5. SCWC is authorized to establish a special condition surcharge to be applied to the quantity rate throughout SCWC's service territory, to amortize the Water Quality OII memorandum account accumulation. The accumulated amount, at the time of this decision, shall be amortized over a 12-month period.

6. SCWC shall conduct a cost study and analysis that shall be the basis for assigning and allocating costs related to its affiliates. The cost study shall reflect the principles, policies and guidelines in Decision 98-06-068. SCWC shall address each point in the holding company settlement that applies to affiliate transactions and costs, and shall show the effect, on both affiliate and utility costs, of implementing appropriate measures to comply with that settlement. SCWC shall include the study and incorporate the results in its next Region III GRC application. SCWC shall also adopt appropriate management policies and accounting practices to ensure that the terms of the holding company settlement are fully implemented.

7. For the Arden-Cordova CSA, SCWC shall record revenues received from the lease of water rights to the City of Folsom in PUC Account 614 ("Other Water Revenues") beginning with the year 2003 and continuing for the duration of the

lease. Those lease revenues shall be credited to the purchased water supply balancing type memorandum account.

8. Application 02-11-007 is closed.

This order is effective today.

Dated _____, at San Francisco, California.